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# U.S. HOUSE OF REPRESENTATIVES
# COMMITTEE ON WAYS AND MEANS

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## WRITTEN COMMENTS

ON

## H.R. 2636

## THE TECHNICAL CORRECTIONS ACT OF 1987

A BILL TO MAKE TECHNICAL CORRECTIONS TO THE TAX REFORM ACT OF 1986, AND FOR OTHER PURPOSES

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## VOLUME II

Comments on Title VII Through Title XI of the Tax Reform Act of 1986

JUNE 9, 1988

Printed for the use of the Committee on Ways and Means by its staff

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FOR IMMEDIATE RELEASE
WEDNESDAY, JUNE 10, 1987

PRESS RELEASE #12
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES
1102 LONGWORTH OFFICE BLDG.
WASHINGTON, D.C. 20515
TELEPHONE: (202) 225-3627

# THE HONORABLE DAN ROSTENKOWSKI (D., ILL.), CHAIRMAN, COMMITTEE ON WAYS AND MEANS, U.S. HOUSE OF REPRESENTATIVES, ANNOUNCES THE INTRODUCTION OF H.R. 2636, THE TECHNICAL CORRECTIONS ACT OF 1987

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The Honorable Dan Rostenkowski (D., Ill.), Chairman, Committee on Ways and Means, U.S. House of Representatives, today announced introduction of H.R. 2636, the Technical Corrections Act of 1987, which would make technical corrections to the Tax Reform Act of 1986 and other tax legislation enacted during the 99th Congress.

In introducing the bill, Chairman Rostenkowski stated, "Whenever legislation as large and comprehensive as last year's Tax Reform Act is passed by Congress, some mistakes must be expected in drafting under such extreme time pressures. Clearly, last year's statute is not drafted with technical accuracy in every respect. Unfortunately, a resolution directing the enrolling clerk to correct certain errors and omissions in the legislation (H. Con. Res. 395), was not passed prior to adjournment of the 99th Congress. Therefore, Senator Lloyd M. Bentsen (D., Texas), Chairman of the Senate Committee on Finance, and I instructed our staffs to work together with all the tax-writing staffs of the Congress and the Treasury Department to review the Tax Reform Act of 1986 and make recommendations for technical corrections and clarifications to that legislation. The staff has recently completed its work, and the bill that the Honorable John J. Duncan, Ranking Republican Member of the Committee, and I are introducing today includes necessary technical changes to last year's landmark legislation."

## BACKGROUND

The Technical Corrections Act of 1987, H.R. 2636, makes corrections to the Tax Reform Act of 1986, the revenue provisions of the Omnibus Budget Reconciliation Act of 1986, the Harbor Maintenance Revenue Act of 1986, and the Superfund Revenue Act of 1986. This legislation is cosponsored by the Honorable Dan Rostenkowski (D., Ill.), Chairman, Committee on Ways and Means, and the Honorable John J. Duncan (R., Tennessee), Ranking Republican Member of the Committee on Ways and Means. The Honorable Lloyd M. Bentsen (D., Texas) is introducing an identical bill in the Senate today, cosponsored by the Honorable Bob Packwood (R., Oregon), Ranking Republican Member of the Senate Finance Committee.

In order to assist those interested in the legislation to understand its contents, the staff of the Joint Committee on Taxation will issue a pamphlet in the near future explaining the provisions of the legislation. The Joint Committee print will be available for sale to the general public. It can be obtained at the GPO bookstore or by calling the Superintendent of Documents at (202) 275-3030 and referring to Description of the Technical Corrections Act of 1987, Jacket no. 73-917.

## WRITTEN STATEMENTS COMMENTING UPON THE LEGISLATION:

Individuals and organizations interested in commenting upon the provisions of this legislation should submit six (6) copies of their written comments by the close of business, Friday, July 10, 1987, to Robert J. Leonard, Chief Counsel, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515.

FOR IMMEDIATE RELEASE
MONDAY, JULY 6, 1987

PRESS RELEASE #15
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES
1102 LONGWORTH OFFICE BLDG.
WASHINGTON, D.C. 20515
TELEPHONE: (202) 225-3627

## THE HONORABLE DAN ROSTENKOWSKI (D., ILL.), CHAIRMAN, COMMITTEE ON WAYS AND MEANS, U.S. HOUSE OF REPRESENTATIVES ANNOUNCES AN EXTENSION OF THE PERIOD FOR SUBMITTING WRITTEN COMMENTS ON H.R. 2636, THE TECHNICAL CORRECTIONS ACT OF 1987

The Honorable Dan Rostenkowski (D., Ill.), Chairman, Committee on Ways and Means, U.S. House of Representatives, today announced that the Committee has extended, until Friday, July 17, 1987, the time period for submitting written comments to H.R. 2636, the Technical Corrections Act of 1987.

In announcing the extension, Chairman Rostenkowski stated, "I am pleased that many interested members of the public have written the Committee commenting upon H.R. 2636, the Technical Corrections Act of 1987, in response to the Committee's press release dated June 10, 1987. These comments will be very helpful to the Members of the Committee and the staff when the Committee acts on this legislation. Due to the Committee's reconciliation schedule which precludes a public hearing, I am announcing an extension of the date for submission of written comments on H.R. 2636 until July 17, 1987."

### BACKGROUND

The Technical Corrections Act of 1987, H.R. 2636, makes corrections to the Tax Reform Act of 1986, the revenue provisions of the Omnibus Budget Reconciliation Act of 1986, the Harbor Maintenance Revenue Act of 1986, and the Superfund Revenue Act of 1986. By press release dated June 10, 1987 (see press release #12), the public was invited to submit written comments on this legislation on or before July 10, 1987. This press release extends the time for filing comments until close of business on July 17, 1987.

### WRITTEN STATEMENTS COMMENTING UPON THE LEGISLATION:

Individuals and organizations interested in commenting upon the provisions of H.R. 2636, the Technical Corrections Act of 1987 should submit six (6) copies of thier written comments by the close of business, Friday, July 17, 1987, to Robert J. Leonard, Chief Counsel, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515.

**SEE FORMATTING REQUIREMENTS BELOW:**

## COMMITTEE ON WAYS AND MEANS FORMATTING REQUIREMENTS FOR PRINTING OF HEARING STATEMENTS, WRITTEN COMMENTS AND EXHIBITS

Each statement presented for printing to the Committee by a witness, any written statement or exhibit submitted for the printed record or any written comments in response to a request for written comments must conform to the guidelines listed below. Any statement or exhibit not in compliance with these guidelines will **not** be printed, but will be maintained in the Committee files for review and use by the Committee.

1. All statements and any accompanying exhibits for printing must be typed in single space on legal-size paper and may not exceed a total of 10 pages.
2. Copies of whole documents submitted as exhibit material will not be accepted for printing. Instead, exhibit material should be referenced and quoted or paraphrased. All exhibit material not meeting these specifications will be maintained in the Committee files for review and use by the Committee.
3. Statements must contain the name and capacity in which the witness will appear or, for written comments, the name and capacity of the person submitting the statement, as well as any clients or persons, or any organization for whom the witness appears or for whom the statement is submitted.
4. A supplemental sheet must accompany each statement listing the name, full address, a telephone number where the witness or the designated representative may be reached and a topical outline or summary of the comments and recommendations in the full statement. This supplemental sheet will not be included in the printed record.

The above restrictions and limitations apply only to material being submitted for printing. Statements and exhibits or supplementary material submitted solely for distribution to the Members, the press and public during the course of a public hearing, may be submitted in other forms.

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- Albright College, Reading, Pa., Patricia N. Moulton, letter.
- All Saints' Episcopal Church, Beverly Hills, Calif., M. Gregory Richards, Rector, statement.
- America's Keswick, Whiting, N.J., William E. Bibik, letter.
- American Baptist Churches, Ministers and Missionaries Benefit Board, New York, N.Y., Dear R. Wright, letter.
- American Baptist Foreign Mission Society, Valley Forge, Pa., William E. Jarvis, letter.
- American Diabetes Association, Oklahoma Affiliate, Inc., Tulsa, Okla., Ann Richards Ketcham, letter.
- American Heart Association, Iowa Affiliate, Mrs. Vicki Kimes, letter.
- American Leprosy Missions, Elmwood Park, N.J., Eugene L. Wilson, letter.
- AMG International, Chattanooga, Tenn., Otto A. Anderson, letter.
- Andrews University, Berrien Springs, Mich., Oliver L. Johnston, letter.
- Anne Carlsen School, Jamestown, N.D., Henry Edwards, letter.
- Arkansas Baptist Foundation, Little Rock, Ark., Harry D. Trulove, letter and attachment.
- Art Center College of Design, Pasadena, Calif., Warren B. Knox, letter.
- Auburn Alumni Association, Auburn University, Ala., Jerry F. Smith, letter.
- Augustana College, Rock Island, Ill., James D. Horstmann, letter.
- Austin College, Sherman Tex.:
  - William R. McLeRoy, letter.
  - J. Thomas Stewart, letter.
- B'nai B'Rith Foundation of the U.S., Sidney H. Closter, letter.
- Baldwin-Wallace College, Berea, Ohio, Thomas H. Konkoly, letter.
- Bangor, Maine, Theological Seminary, Susan L. Grove-Markwood, letter.
- Baptist Bible College & Theological Seminary, Clarks Summit, Pa., Milo Thompson, Jr., letter.
- Baptist Foundation of Oklahoma, Oklahoma City, Okla., Robert L. Ross, W.G. Kersh, and C. Duane Riley, joint letter.
- Baptist Health Services Foundation, Gadsden, Ala., George P. Gray, Jr., letter.
- Baptist Hospital Fund, Midway and Mounds Park Hospitals, St. Paul, Minn., James B. Field, letter.
- Barlow, Argus S., Brevard, N.C., letter.
- Bates College, Lewiston, Maine, Eugene G. Taylor, letter.
- Baylor University Medical Center Foundation, Dallas, Tex., Dan T. Garrett, letter.
- Bellevue College Foundation, Bellevue, Neb., Patricia J. Morocco, letter.
- Berea College, Berea, Ky., Lou S. Lakes, letter.
- Betheny College, Lindsborg, Kansas, R. Jay Ribble, and Donald E. Trued, letters.
- Bethphage Mission, Inc., Omaha, Neb., David A. Jacox, letter.
- Bible Literature International, Columbus, Ohio, James R. Falkenberg, President.
- Biola University, La Mirada, Calif., Gary R. Boren, letter.
- Blair Academy, Blairstorn, N.J., Mary C. Tychonievich, letter.
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- Boys Club of Fort Worth, Tex., Tracey Brown, letter.
- Bradley University, Peoria, Ill., Ian T. Sturrock, letter.
- Brebeuf Preparatory School, Indianapolis, Inc., M. Joseph Casey, S.J., letter.

Bremwood Lutheran Children's Home Society, Waverly, Iowa, Harold Hunter, letter.
Brevard College, Brevard, N.C., Mark A. Bailey, letter.
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Calumet College, Whiting, Ind., Father Ronald J. Schiml, C.PP.S., letter.
Calvin College and Seminary, Grand Rapids, Mich., John Heerspink, letter.
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Canton, Ohio, Christian Home, Larry Burgett, letter.
Capper Foundation, Topeka, Kansas, Edward F. Gibbons, and Monty E. Nelson, joint letter.
Carle Foundation, Urbana, Ill., W. Frank Elston, letter.
Carlisle Group, Carlisle, Pa., George W. Bahner, letter.
Case Western Reserve University, Frances Payne Bolton School of Nursing, Cleveland, Ohio, Sandra Deller, letter.
Catholic Archdiocese of Seattle, Wash., Steve Kocharhook, letter.
Catholic Chancery, Diocese of Kansas City-St. Joseph, Mo., Denis Putthoff, letter.
Catholic Charities of the Archdiocese of Dubuque, Iowa, James L. Yeast, letter.
Catholic Foundation, Dallas, Tex., Hal F. Tehan, letter.
Catholic Missions Office, Diocese of Joliet, Ill., Rev. John P. Driscoll, letter.
Cedarville, College, Cedarville, Ohio, Martin E. Clark, and Robert K. Rohm, letters.
Center for Creative Studies, Detroit, Mich., Dennis E. Moore, letter.
Chaddock, Quincy, Ill., Marge Ozley.
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Chicago School of Professional Psychology, Kathleen Slomski, letter.
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Children's Hospital National Medical Center, Washington, D.C., Terry L. Lierman, and Thomas D. Walsh, joint letter.
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Christian Appalachian Project, Lancaster, Ky., William A. Begley, letter.
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Christian Record Braille Foundation, Inc., Lincoln, Neb., Vernon L. Bretsch, letter.
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Church of Jesus Christ of Latter-Day Saints, Ron S. Taylor, letter.
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Clark University, Worcester, Mass., Rilchard P. Traina, letter.
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Eastern College, Eastern Baptist Theological Seminary, St. Davids, Pa., William R. Rueckle, letter.
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Elyria, Ohio, United Methodist Home, Charles V. Watt, letter.
Episcopal Church Center, New York, N.Y., Frederick Osborn III, letter.
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FCNL Education Fund, Washington, D.C., Edward F. Snyder, letter.
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Four County Mental Health Services, Inc., St. Charles, Mo., Karl Wilson, and Jill Ditchik, joint letter.
Fox Chase Cancer Center, Philadelphia, Pa., Sandra W. Weckesser, letter.
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Friends of Israel Gospel Ministry, Inc., Bellmawr, N.J., William E. Sutter, Fred Hartman, Marvin J. Rosenthal, and William C. Varner, joint letter.
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Girl Scouts, Plymouth Bay Girl Scout Council, Inc., Taunton, Mass., Robert A. Lewis, letter.
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Good Samaritan Society, Sioux Falls, S.D., Raymond L. Mehl, and Randy Fitzgerald, joint letter.
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Hartwick College, Oneonta, N.Y., Meryl E. Best, letter.
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Holy Cross Hospital Foundation, Fort Lauderdale, Fla., Lana C. Wingerson, letter.
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Houghton College, Houghton, and West Seneca, N.Y., Ralph C. Young, letter.
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July 23, 1987

99999-104
OUR REFERENCE

The Honorable Dan Rostenkowski
Chairman
Committee on Ways and Means
United States House of Representatives
Washington, D.C. 20515

Re: Technical Corrections Act of 1987
(H.R. 2636 and S. 1350) ("TCA")

Dear Sir:

As the United States Congress considers the above-referenced bills, I am writing to respectfully request that consideration be given to an amendment to the Tax Reform Act of 1986 ("Act") not contemplated in the text of the TCA as introduced on June 10, 1987.

Section 701(a) of the Tax Reform Act of 1986 amended Section 56 of the Internal Revenue Code of 1954 (redesignated as the Internal Revenue Code of 1986 by Section 2(a) of the Act) ("Code"). In particular, that provision added a new subsection (f) to Section 56 of the Code, creating a new tax preference for corporate alternative minimum tax purposes equal to 50 percent of the excess (if any) of a corporation's "adjusted net book income" over its alternative minimum taxable income determined without regard to this new preference or to the alternative tax net operating loss deduction.

Section 56(f)(2)(A) defines the term "adjusted net book income" to mean the net income or loss shown on the corporation's applicable financial statement after adjustments set forth in the statute. One of these adjustments is defined as follows:

> In the case of any corporation which is not included on a consolidated return with the taxpayer, adjusted net book income shall take into account the earnings of such other corporation only to the extent of the sum of the dividends received from such other corporation and other amounts required to be included in gross income under this chapter in respect of the earnings of such other corporation.

Section 56(f)(2)C)(ii) of the Code (emphasis supplied). By contrast, the Statement of Managers accompanying H.R. 3838 states only in regard to this adjustment that "[e]arnings of a corporation that does not file a consolidated tax return with the taxpayer are taken into account only to the extent of dividends received from the other corporation." H. Rep. No. 99-841, 99th Cong., 2d Sess. II-272 (1986) ("Statement of Managers") (emphasis added). Thus, the Statement of Managers does not contain any express reference to the "other amounts required to be included in gross income" which are mentioned in the last portion of Section 56(f)(2)(C)(ii) of the Code.

An indication of the possible interpretation of the last portion of Section 56(f)(2)(C)(ii) of the Code is given by a notice of proposed rulemaking published in the Federal Register on April 28, 1987, in which the Internal Revenue Service ("I.R.S.") issued proposed regulations ("Proposed Regulations") under Section 56 of the Code.

Section 1.56-1T(b)(2)(iv) of the Proposed Regulations provides that "net book income" (the starting point for computing "adjusted net book income") for purposes of the alternative minimum tax on corporate taxpayers includes the earnings of affiliates not joining the taxpayer in the filing of a consolidated Federal income tax return only to the extent of amounts required to be included in the taxpayer's gross income.

Section 1.56-1T(b)(6) of the Proposed Regulations contains examples illustrating the calculation of "adjusted net book income" in situations governed by Section 1.56-1T(b)(2)(iv) of the Proposed Regulations. Example (3) sets forth the situation of a U.S. corporation and its wholly-owned foreign subsidiary, which is a controlled foreign corporation within the meaning of Section 957 of the Code. The U.S. corporation's applicable financial statement includes its subsidiary, and both of them are on the same taxable and fiscal year. For 1987, and pursuant to Section 951 of the Code, the U.S. parent includes $100 in its gross income, representing all of its subsidiary's Subpart F income for that year. Even though, under Section 1.56-1T(b)(iv) of the Proposed Regulations, that $100 inclusion is not reflected on the U.S. parent's applicable financial statement for 1987, the example concludes that the $100 inclusion must nevertheless be reflected in the U.S. corporation's "adjusted net book income" for alternative minimum tax purposes.

Similarly, example (4) of Section 1.56-1T(b)(6) of the Proposed Regulations describes a foreign corporation which pays $30 in foreign taxes and distributes a $100 dividend to a U.S. corporation which owns 20 percent of the distributing corporation's stock. The U.S. shareholder uses the equity method of accounting for financial purposes, and therefore eliminates the dividend on its applicable financial statement. Both corporations use the same taxable and fiscal year. Under Sections 61 and 78 of the Code, the U.S. corporation includes $130 in gross income and claims the derivative foreign tax credit under Section 902 of the Code. The example concludes that the $130 dividend must be included in the U.S. corporation's "adjusted net book income" for alternative minimum tax purposes, despite the proper elimination of the intercompany dividend from the U.S. corporation's applicable financial statement.

It seems clear that the I.R.S. interpretation of the last portion of Section 56(f)(2)(C)(ii) of the Code contained in Section 1.56-1T(b)(2)(iv) of the Proposed Regulations and illustrated by the above examples is a permissible implementation of the statutory language. However, as illustrated by the results given in the above examples, it is respectfully submitted that the policy underlying that statutory provision is suspect in light of the overall purpose of the corporate alternative minimum tax and should therefore be re-examined in the course of deliberations on the TCA.

The purpose of the alternative minimum tax preference on one-half of a corporate taxpayer's business untaxed reported profits is to ensure that, regardless of other deductions, exclusions and credits available to the taxpayer for regular tax purposes, at least some portion of economic income and gain will be subject to tax. See S. Rep. No. 99-313, 99th Cong., 2d Sess. 518 (1986). By contrast, constructive income inclusions required under various provisions of the Code for tax purposes (for instance, the deemed dividend under Subpart F) do not reflect economic income, since no money or property is actually transferred to the taxpayer: rather, in the case of Subpart F income, economic income only accrues when the previously taxed Subpart F income is actually repatriated to the U.S. shareholder on a tax-free basis under Sections 959 or 1248 of the Code.

Accordingly, in the situation described in example (3) of Section 1.56-1T(b)(6) of the Proposed Regulations, the U.S. parent is not in receipt of economic income or gain when it includes the $100 of its subsidiary's Subpart F income in its own gross income under Section 951 of the Code. Instead, it is in receipt of such economic gain or income when that $100 amount is actually distributed to it under Sections 959 or 1248 of the Code.

However, the applicable provisions of the Code as currently in effect (and as would be in effect after enactment of the TCA as now drafted) compel exactly the opposite result for corporate alternative minimum tax purposes. While the last portion of Section 56(f)(2)(C)(ii) of the Code requires inclusion of Subpart F income in "adjusted net book income" at the same time and to the same extent as it is included in gross income under Section 951 of the Code, the portion of Section 56(f)(2)(C)(ii) of the Code which requires inclusion of dividends in "adjusted net book income" effectively excludes distributions of previously taxed Subpart F income from "adjusted net book income" when read in conjunction with Section 959(d) of the Code.

It is respectfully submitted that the operation of the statute in the factual pattern addressed in Example (3) of Section 1.56-1T(b)(6) of the Proposed Regulations is inappropriate in light of the avowed legislative intent behind the new corporate alternative minimum tax provisions. If viewed on a non-consolidated basis, a United States corporation does not recognize either economic gain or reportable income for financial accounting purposes when a subsidiary earns income, even though the Code, as an anti-tax-deferral device, requires current taxation of that income to the United States corporation under Subpart F of the Code. Rather, the U.S. corporation's economic gain and reportable income for financial accounting purposes accrue when the subsidiary's income is repatriated by dividend or liquidation.

The situation described in example (4) of Section 1.56-1T(b)(6) of the Proposed Regulations appears to be somewhat different. It is true that the $30 being included in the U.S. corporation's gross income under Section 78 of the Code does not represent an actual distribution to it of money or property. However, the inclusion is related to an economic gain of the U.S. corporation, namely, the use of the derivative foreign tax credit in the same amount under Section 902 of the Code. Accordingly, it seems appropriate to include that inclusion in "adjusted net book income" for alternative minimum tax purposes, since the inclusion is merely a method of accounting for the derivative foreign tax credit being claimed by a taxpayer that did not in fact pay the foreign tax underlying that credit. Indeed, such treatment is consistent with the treatment, for corporate alternative minimum tax purposes, of possession withholding taxes imposed on dividends paid to U.S. corporate shareholders by corporations having elections in place under Section 936 of the Code. See Section 56(f)(2)(F) of the Code and Statement of Managers II-273.

Accordingly, it would seem more consonant with the overall avowed legislative intent behind the new corporate alternative minimum tax provisions to amend Section 56(f)(2)(C)(ii) of the Code to eliminate the reference to "other amounts required to be included in gross income under this chapter" and to clarify that the term "dividends" as used in that provision includes amounts so treated under Sections 78 and 1248 of the Code. A corresponding amendment would exclude Section 56(f)(2)(C)(ii) of the Code from the operation of Section 959(d) of the Code. Of course, the I.R.S. would be expected to modify the Proposed Regulations to conform to such amendments.

A letter substantially identical hereto is being sent to the Chairman of the Senate Finance Committee. Thank you for your kind attention to the foregoing.

Respectfully submitted,

Richard E. Andersen

REA/hr

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July 16, 1987

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Re: H.R. 2636 - Amendments to Title VII
Nonconventional Fuels Credit

Dear Mr. Leonard:

This letter is in response to the request of the Ways and Means Committee for comments on H.R. 2636, the Technical Corrections Act of 1987. The purpose of this letter is to identify a technical problem relating to the interaction between the alternative minimum tax ("AMT") imposed under Title VII of the 1986 Act and the nonconventional fuels credit allowed under section 29 of the Internal Revenue Code and to propose a technical correction that would solve that problem.

The purpose of Congress in enacting the nonconventional fuels credit was to protect investments in nonconventional fuels projects against declines in the price of oil. See H. Rep. No. 817, 96th Cong., 2nd Sess. 139 (1980). The credit is in the nature of a price subsidy and is based on the quantity of nonconventional fuels produced and the degree to which oil prices have fallen below a statutory minimum.

Under Code section 55, as amended by the 1986 Act, the AMT is calculated as the excess of the tentative minimum tax over the regular tax. One of the objectives of the 1986 amendments to the AMT was to ensure that incentive tax credits such as the nonconventional fuels credit could not be accumulated in a single year to such an extent that they eliminate all tax liability for the year. Accordingly, Congress amended each of the Code sections that allows an incentive credit to prevent the use of incentive credits to reduce regular tax to an amount less than the tentative minimum tax. One of the fundamental assumptions underlying this change was that credits disallowed in one year could be carried forward to subsequent years in which the taxpayer's regular tax liability exceeds its AMT liability. This assumption was reflected in both the House and Senate versions of the Act and was described in the Statement of Managers as follows:

> Under the House bill, incentive tax credits generally are not allowed against the minimum tax. Credits that do not benefit the taxpayer due to the minimum tax can be used as credit carryovers against the regular tax. Corporations with net operating losses in two of the last three years before 1986 can use pre-1986 credits to offset 75 percent of minimum tax liability. . . .
>
> . . . .
>
> The Senate amendment is the same as the House bill, except that no credits can be used by any corporation to offset minimum tax liability.
>
> . . . .
>
> The Conference agreement generally follows the Senate amendment, except that as a transition rule, regular investment tax credits are permitted, in effect, to reduce minimum tax liability by 25 percent.

H.R. Rep. No. 841, 99th Cong., 2nd Sess. II-280 (1986) (emphasis added).

The plain meaning of the underscored language from the Statement of Managers is that Congress anticipated that an incentive credit that was disallowed solely because of the AMT would be available as a carryover in subsequent years. Notwithstanding the Conference Committee's anticipation of how the law would work, the effect of the applicable Code provisions, in the case of the nonconventional fuels credit, is permanently to disallow the credit if its use is limited by the AMT. *See* I.R.C. § 29(b)(5).

A permanent disallowance of the nonconventional fuels credit by application of the AMT provisions would have a unique effect on that credit. Because the credit is based on production, it can only be claimed after the project has come "on line" and production has commenced. Thus, the credit may not be available until long after the taxpayer's investment in a nonconventional fuels project has been made. In this respect, the nonconventional fuels credit differs from other incentive credits, which generally may be claimed in the taxable year when the taxpayer makes the expenditure that will qualify the taxpayer for a credit. For example, the targeted jobs credit is claimed in the year when qualified wages are paid. The research credit is claimed in the year when qualified research expenses are incurred. The investment credit is claimed when the taxpayer places new section 38 property into service. (Although property may be placed in service in a year later than the year in which it is paid for, deferral of the credit can be avoided by electing an investment credit for "qualified progress expenditures".)

For most incentive credits, the taxpayer will generally be in a position to determine in the year of expenditure whether the AMT rule would deprive the taxpayer of a meaningful credit. Since the nonconventional fuels credit is not claimed until after the investment has been made and production has come on line, it is virtually impossible for the taxpayer at the time of investment to determine whether the AMT will deprive the taxpayer of a meaningful credit.

There is no reason to believe that Congress wanted the 1986 Act to dilute the tax incentive for investment in nonconventional fuels. Certainly the Committee Reports failed to alert members that the nonconventional fuels credit would be eliminated if the fuels were sold in a year when AMT applied. Moreover, the contrary, recent Congressional statements of concern that our dependence on imported oil has returned to the levels that preceded the 1973 oil embargo indicate that the policy behind the nonconventional fuels credit is as valid as ever.

We believe that the Congressional purpose of allowing a meaningful nonconventional fuels credit and of allowing a carryover of credits limited by the AMT will be effectuated only if the 1986 Act is corrected. Allowing a minimum tax credit carryover for any nonconventional fuels credits disallowed by operation of the AMT would be the most acceptable manner of correcting the 1986 Act, since it would limit the carryover to the narrow situation in which the problem occurs. Specifically, we propose that section 53(d)(1)(A) of the Code be amended by deleting the period at the end thereof and adding the following:

> "increased to the extent of the credits not allowable against regular tax by reason of section 29(b)(5)."

If you have any questions concerning the merits or mechanics of our proposed technical correction, please call me or my colleague Bill Chip.

With best wishes,

Sincerely yours,

Donald C. Alexander

## COMPAQ COMPUTER CORPORATION

## PROPOSED REVISION OF RULES REQUIRING INCLUSION OF INCENTIVE STOCK OPTION SPREAD IN ALTERNATIVE MINIMUM TAXABLE INCOME FOR TAXABLE YEAR OF EXERCISE

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Section 57(a)(3) of the Internal Revenue Code of 1986 (the "Code") requires the spread between value and exercise price of stock received on exercise of an incentive stock option ("ISO") to be included in income for alternative minimum tax ("AMT") purposes at the time of exercise. The General Explanation of the 1986 Act states that the spread on exercise was intended to constitute an item of tax preference even if the stock is later the subject of an early disposition. Prior to the enactment of the Tax Reform Act of 1986, the ISO spread on exercise was not subject to inclusion in income for AMT purposes if the ISO stock was later the subject of an early disposition, because the early disposition caused the spread to be taxed as ordinary income. Section 57(a)(3) of the Code should continue to exclude the ISO spread on exercise from income for AMT purposes in those cases in which an early disposition is made either on or before the close of the taxable year of exercise, or after the taxable year of exercise where the sole reason for the delay in disposition is due to the application to the taxpayer of section 16(b) of the Securities and Exchange Act of 1934 (the "Exchange Act").

The ISO preference item was included as an item of tax preference income because the spread on exercise is deferred income recognized for regular tax purposes when a disposition of the ISO stock is later made. Generally, all such "deferred" items are elective, meaning the taxpayer could avoid inclusion of the item (or an adjustment to taxable income) for AMT purposes by simply not availing himself or herself of the tax deferral. Clearly, no deferral is enjoyed by a taxpayer who makes an early disposition of stock on or before the close of the taxable year of exercise; thus, such a taxpayer should not be required to incur the time and expense of computing the ISO spread on the exercise date, including that spread in income for AMT purposes, and determining whether regular tax or AMT should be the basis for making estimated tax payments.

In addition, in the case of a taxpayer who is subject to section 16(b) of the Exchange Act, exercise of an ISO within six months prior to the end of the taxable year of exercise will not permit a taxpayer who wishes to make a disqualifying disposition to do so before the end of such taxable year because such a sale would cause the loss of the taxpayer's economic profit by operation of section 16(b) of the Exchange Act. Such a taxpayer must wait until after the lapse of the 16(b) six-month holding period, and thus must sell the option shares after the close of the taxable year of exercise. Since this deferral is not elective, but rather is compelled by the operation of a non- tax federal statute, this deferral should not be subject to the AMT.

Accordingly, section 57(a)(3) of the Code should be amended so that the ISO spread is not an item of tax preference for the year of exercise by a taxpayer if the shares purchased on exercise of the ISO are either (a) disposed of by the taxpayer in a disqualifying disposition on or before the close of the taxable year of exercise, or (b) subject to the provisions of section 16(b) of the Exchange Act in the hands of the taxpayer and are disposed of by the taxpayer in a disqualifying disposition within 120 days after the lapse of the section 16(b) holding period applicable with respect to such shares. The 120-day grace period for sale is required because in the case of COMPAQ Computer Corporation, internal corporate policy prevents executives who are "insiders" and who may have exercised ISO's from selling the option stock until the quarterly earnings report of the corporation has been released, and the 120-day period will give such an executive approximately an additional 30 days from such release to consider the economic issues involved in a decision to sell or not sell option stock. A 120-day "grace" period is also appropriate because it permits executives who are "insiders" to "trickle" options into the market over a longer period of time, thereby avoiding the adverse market impact that might result from the "dumping" of large blocks of stock into the market in a short period of time. Large numbers of executives hold serially issued options, so this "dumping" problem is very real.

The relief sought for taxpayers subject to section 16(b) of the Exchange Act is similar to the relief granted such taxpayers in Public Law Number 97-34, Section 252(a), which added section 83(c)(3) to the Code. This provision, by treating stock as subject to a substantial risk of forfeiture during the period it is subject to section 16(b) of the Exchange Act, permitted taxpayers to defer recognition of income by reason of their receipt of such stock for services until they were able to sell the stock and obtain cash to pay the tax. Similarly, by not requiring the inclusion in income for AMT purposes of stock received on exercise of an ISO until after the taxpayer is able to sell the stock and obtain cash to pay the tax, the relief sought advances the laudable policy of not requiring taxpayers to incur tax liability with respect to appreciation in property before they have converted the appreciated property into cash that enables them to pay the tax. In addition, such a result will alleviate underpayment of estimated tax penalties for individuals who for some reason cannot pay estimated tax on AMT until the option stock is sold. Accordingly, COMPAQ Computer urges the careful consideration of the attached proposed amendment to section 57(a)(3) of the Code.

## PROPOSED AMENDMENT TO CODE SECTION 57(a)(3)

Section 57(a)(3) of the Internal Revenue Code of 1986 would be amended to read as follows:

(3) INCENTIVE STOCK OPTIONS.--

(A) IN GENERAL. - Except as otherwise provided in subparagraph (B), with respect to a transfer of a share of stock pursuant to the exercise of an incentive stock option (as defined in section 422A, but without regard to the holding period requirement of paragraph (1) of subsection (a) of section 422A), the amount by which the fair market value of the share at the time of exercise exceeds the option price. For purposes of this paragraph, the fair market value of a share of stock should be determined without regard to any restriction other than a restriction which, by its terms, will never lapse.

(B) CERTAIN DISQUALIFYING DISPOSITIONS. - Subparagraph (A) shall not apply to a share of stock that is disposed of prior to the lapse of the period specified in paragraph (1) of subsection (a) of section 422A if

(i) the disposition occurs on or before the last day of the taxable year in which the share of stock is transferred to the taxpayer pursuant to the exercise of the incentive stock option, or

(ii) in the case of a share of stock transferred on exercise of an incentive stock option to a taxpayer subject to section 16(b) of the Securities and Exchange Act of 1934, the disposition occurs on or before the 120th day following the last day of the period during which the sale of the share at a profit could subject the taxpayer to suit under section 16(b) of the Securities and Exchange Act of 1934.

(C) BASIS ADJUSTMENT. - In determining the amount of gain or loss recognized for purposes of this part on any disposition of a share of stock acquired pursuant to an exercise (in a taxable year beginning after December 31, 1986) of an incentive stock option, the basis of such stock shall be increased by the amount (if any) of the excess referred to in subparagraph (A) that constitutes an item of tax preference.

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July 17, 1987

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Washington, DC 20515

In Re: H.R. 2636 - Technical Corrections Act of 1987

Dear Mr. Chairman:

We are submitting these comments on behalf of a client to call your attention to a matter that we believe should be considered in the context of the Technical Corrections Act of 1987 (H.R. 2636 and S. 1350). For purposes of determining the book income adjustment under the corporate alternative minimum tax (AMT), we have discovered that in situations involving affiliated corporations not filing consolidated tax returns, intercompany dividends can generate more book income than actual dividends paid. We believe that the statute needs to be changed to rectify this inequity.

### The Problem

Internal Revenue Code Section 56(f) provides for adjustments to book income for corporations in determining their AMT. Section 56(f)(2)(C) provides the only statutory guidance on the treatment of related corporations. This subsection provides that when consolidated tax returns are filed, adjusted book income of the taxpayer shall take into account items properly allocable to group members included in the return. When an affiliated member is not included in the consolidated return, adjusted book income shall include the dividends received from such affiliated members.

In essence, what the statute contemplates here is one book income calculation for the consolidated return group and separate calculations for affiliated members filing separate returns. The problem that arises under this approach is that dividend payments among affiliated group members that do not file a consolidated tax return are included as a book income adjustment at each level, causing the same dividend payment to be included in the book income of multiple corporations.

In our case, the corporation files a consolidated financial statement but separate tax returns. We have found that in "deconsolidating" the financial statement to compute book income for each separate corporation, dividend payments from a subsidiary to the parent result in a book income adjustment for the parent. If the dividend is paid through another subsidiary, another book income adjustment is created; if dividends are paid through multiple subsidiaries, a book income adjustment is created at each level. This multiple counting creates a penalty for not filing a consolidated tax return that we believe is unwarranted and requires legislative action to correct.

### The Proposed Regulations

The Treasury Department's recently proposed regulations regarding the corporate AMT book income adjustment do not resolve this matter. Under Prop. Reg. §1.56-1T(d)(6)(i)(C), if consolidated financial statements are used but separate tax returns are filed, to determine adjusted net book income of the parent corporation and of the subsidiaries, any consolidating eliminating entries attributable to the separate companies must be removed. This means that any consolidating, eliminating entries that were used to eliminate the double counting attributable to intercompany dividends must be "backed-out" in reaching adjusted net book income.

With respect to the subsidiaries, their adjusted net book incomes would reflect dividends received from other related corporations as reported in their separate financial statements (presumably trial balances made available to the parent for consolidation purposes). Prop. Reg. §1.56-1T(c)(5)(i)(C). No adjustments would evidently be permitted to eliminate the double counting of separate company intercompany dividends.

Because no adjustment seems to be allowed under the proposed regulations for dividends paid to affiliated companies not filing consolidated tax returns, income is created for book income addition purposes that has been taxed at another entity level. This effectively creates a penalty for not filing a consolidated tax return.

Illustration

When a consolidated financial statement is "deconsolidated" to determine a book income amount for each subsidiary filing its own Federal income tax return, the potential for double counting is introduced. If not eliminated through adjusting entries, we have found that this problem is exacerbated when intercompany dividend payments are made to the parent through tiers of subsidiaries.

The following example illustrates this problem:

Parent Corporation, a calendar-year corporation, holds a wholly owned subsidiary, X, which in turn is a holding company for the stock of Y, an operating subsidiary. In 1987, Y has $100 of earnings and out of those earnings pays a $100 dividend to X. X in turn pays a $100 dividend to Parent, which distributes the dividend to its shareholders. Parent, X and Y have no other earnings. Parent, X and Y use a consolidated financial statement, but file separate Federal income tax returns.

For AMT purposes, it appears that the 1987 book income additions for Parent, X and Y under IRC §56(f) are computed separately as follows:

Book income addition for Y:

| | TAX | | BOOKS |
|---|---|---|---|
| Operating Income | $100 | Operating Income | $100 |
| Taxable Income | $100 | Net Book Income | $100 |

Y's BOOK INCOME ADDITION TO AMTI $-0-

Book income addition for X:

| | TAX | | BOOKS |
|---|---|---|---|
| Dividend Income from Y | $100 | Dividend Income from Y | $100 |
| Dividends received deduction | (100) | | -0- |
| Taxable Income | $-0- | Net Book income | $100 |

X's BOOK INCOME ADDITION TO AMTI $50

Book income addition for Parent:

| | TAX | | BOOKS |
|---|---|---|---|
| Dividend Income from X | $100 | Dividend Income from X | $100 |
| Dividends received deduction | (100) | | -0- |
| Taxable Income | $-0- | Net Book Income | $100 |

PARENT'S BOOK INCOME ADDITION TO AMTI $50

Summary for Parent, X and Y:

| | Consolidated Return | Separate Returns |
|---|---|---|
| Total Net Book Income | $100 | $300 |
| Total Taxable Income | $100 | $100 |
| Total Book Income Addition to AMTI | $-0- | $100 |

If Parent, X and Y had filed a consolidated tax return for 1987, no book income addition would be required because consolidating, eliminating entries on the books would have eliminated any difference between book and tax. Because separate tax returns are filed for Parent, X and Y, book income additions totaling $100 ($50 from X and $50 from Parent) are created, potentially triggering the corporate AMT for X and parent.

Note: If Parent had additional tiers of subsidiaries, each tier would have another $50 book income addition. For example, if three tiers of subsidiaries were involved, book income additions would total $150, an amount in excess of the $100 dividend paid.

## Recommendation

Congress intended that the book income addition would compel corporations to pay at least some tax when reporting substantial earnings to the public. In this situation, because a consolidated financial statement is prepared, there are no earnings being reported for book purposes that are not reported for tax purposes as a result of intercompany dividends. There is no question of untaxed income. It is only because the taxpayer files separate tax returns for parent and subsidiaries that a book income addition is created. This rule creates an unwarranted penalty for not filing a consolidated tax return and unfairly penalizes those who cannot file a consolidated return or choose not to do so.

To eliminate the double counting of intercompany dividends in this context, we recommend that the inequity in the book income adjustment for a group of related companies not filing a consolidated income tax return be eliminated by providing a statutory rule for an adjustment to net book income for intercompany dividends paid when a consolidated financial statement is used.

Thank you for your attention to this matter. If you have any further questions, please contact Pamela Pecarich or Sam Starr of National Tax Services at 202/822-4000.

Sincerely,

David T. Wright
National Director of Tax Services

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June 30, 1987

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Dear Sir:

The purpose of this letter is to comment on a provision of the Technical Corrections Act of 1987 (the "Act") which significantly alters the application of the alternative minimum tax to incentive stock options ("ISO's"). The provision would require an individual taxpayer to be subject to the alternative minimum tax on the exercise of an ISO even if he makes an early, or disqualifying, disposition of the ISO shares. This is a significant substantive change from current law; it is certainly more than a technical correction.

Section 107(c)(4) of the Act provides that subparagraph A of § 57(a)(3) of the Code is amended by striking out "section 422A" and inserting in lieu thereof "section 422A whether or not the holding period requirements of section 422A(a) are met." This proposed amendment to § 57 is troublesome as it is contrary to the intent of Congress which is expressed in the legislative history of the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA") which enacted § 57(a)(10) of the Code (§ 57(a)(10) was redesignated § 57(a)(3) by the Tax Reform Act of 1986 ("TRA")) and a recent Private Letter Ruling issued by the Internal Revenue Service (the "Service"). There was no indication in TRA or the legislative history thereto that would have alerted taxpayers to this significant change in the minimum tax rules as they apply to ISOs. The proposed change becomes even more significant because of its apparent effective date.

The Economic Recovery Act of 1981 ("ERTA") established a new kind of stock option, an incentive stock option, under § 422A of the Code. Section 422A(a)(1) of the Code provides that § 421(a) shall apply with respect to the transfer of a share of stock to an employee pursuant to his exercise of an ISO if no disposition of such share is made by him within two years from the date of the granting of the option nor within one year after the transfer of such share to him. Pursuant to § 421(a), an employee who is granted a qualified ISO realizes no income upon the grant or exercise of the option. ERTA did not amend the tax preference provisions of § 57 of the Code at the time it created ISO's to include the difference between the ISO exercise price and the fair market value of the stock at the time of exercise (the "spread") as an item of tax preference for purposes of the minimum tax rules. Congress' decision to exclude the ISO spread from the list of tax preference items was particularly notable because of the prior law, specifically § 57(a)(6) of the Code, which treated the spread on the exercise of a restricted or qualified stock option, the predecessors to ISO's, as a tax preference item for purposes of the minimum tax.

Section 301 of the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA") amended § 57 of the Code in 1982 to include the ISO spread as an item of tax preference. In enacting § 57(a)(10), however, Congress specifically provided that "[i]t was not intended that the incentive stock option preference apply . . .

where the special tax treatment for incentive stock options does not apply because there is an early disposition, as specified in section 422A(a)(1), of the stock acquired through the exercise of the option." See H.R. Rep. No. 97-760 (Conf. Rep.), 97th Cong. 2d Sess. 475 (1982), 1982-2 C.B. 600, 603.

Taxpayers have correctly interpreted the above-quoted language from the TEFRA Conference Report to mean that the imposition of the minimum tax is avoided by selling the purchased ISO shares within either two years from grant or one year from exercise of the ISO. Taxpayers have also taken the position that such early or "disqualifying" disposition avoids the minimum tax even if the sale takes place in a subsequent taxable year.

The regulations issued pursuant to § 57 of the Code, as it applied to qualified and restricted stock options, specifically addressed the inapplicability of the minimum tax rules in the event of an early disposition of the option stock. Treas. Reg. § 1.57-1(f)(5)(i) provided that § 57(a)(6) was inapplicable if during the same taxable year in which stock was transferred pursuant to the exercise of an option, the transferee made a disposition of the option stock.

The fact that the legislative history to § 57(a)(10) did not specifically restrict the inapplicability of the minimum tax rules to a disposition of ISO stock which occurred in the same taxable year as the exercise of the underlying option, as Treas. Reg. § 1.57-1(f)(5)(i) had required for qualified and restricted stock options, is significant. Taxpayers have rightfully determined that an early disposition of ISO stock, even in a taxable year subsequent to the year of exercise, would render the minimum tax inapplicable to the ISO exercise. The Service recently confirmed this position in Private Letter Ruling ("PLR") 8713054 (December 30, 1986).* Section 107(c)(4) of the Act directly contravenes this ruling.

Under the facts of PLR 8713054, an individual received ISO's from his employer to purchase shares of the corporation's stock. The employee exercised certain of the ISO's on June 16, 1986. The employee proposed to dispose of the ISO stock between January 1, 1987 and June 16, 1987. The employee requested a ruling as to whether the ISO spread would be a tax preference item under § 57(a)(10) of the Code in the year of exercise of the ISO.

The ruling reviews the minimum tax rules of §§ 55 and 57 of the Code as they apply to ISO's. It discusses the TEFRA provision which first applied the minimum tax rules to ISO's and it states that "[i]n enacting section 57(a)(10), Congress did not intend for the incentive stock option preference to apply where there is (sic) early disposition of the stock acquired through the exercise of the option."

In the case presented, the individual intended to make an early or disqualifying disposition of the ISO stock in that he would sell the stock within one year of his exercise of the ISO. This would qualify as an early disposition under § 422A(a)(1) of the Code and would, therefore, preclude application of § 421(a) to the proposed transaction. The Service concludes in the ruling that § 57(a)(10) will not apply to the ISO spread upon the proposed disposition of stock, provided that the individual does in fact dispose of such stock between January 1, 1987 and June 16, 1987 (i.e., makes a disqualifying disposition).

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* While § 6110(j)(3) of the Code provides that private letter rulings may not be used or cited as precedent, such rulings do provide insight into the Service's position on certain issues. PLR 8713054 is discussed herein for that purpose.

TRA made two changes to § 57 and the minimum tax rules as they apply to ISO's. First, it redesignated § 57(a)(10) as § 57(a)(3). Second, it added § 57(a)(3)(B) which provides a basis adjustment in determining the amount of gain or loss on a subsequent sale of ISO shares for minimum tax purposes only. TRA did not amend in any way the basic rule of § 57(a)(10) that the ISO spread is an item of tax preference. The fact that the Act would now propose a significant change to that rule is difficult to accept and hardly qualifies as merely a technical correction.

The Private Letter Ruling was published after the enactment of TRA; the proposed transaction was to take place after the effective date of the changes made to § 57 by TRA. That the Service interpreted the TRA changes to § 57 to be irrelevant to this question is obvious. The Act would now reject this well-reasoned position without any justification.

An additional aspect of the proposed change to § 57(a)(3) which is troubling is its effective date. As currently drafted, § 107(c)(4) of the Act does not provide a specific effective date for the amendment contained therein. As a result, § 119 of the Act would appear to be applicable. Section 119 states that except as otherwise provided in the Act, any amendment made thereby "shall take effect as if included in the provision of the Reform Act to which such amendment relates." This would seem to make the change in the Act effective for tax years beginning after December 31, 1986, since the changes to § 57(a)(10) of the Code made by TRA are effective at that time. It would thus be retroactive to the beginning of 1987. This is extremely unfair particularly in light of the issuance of PLR 8713054.

There have been no indications in TRA or the legislative history thereto or since enactment of TRA which would have put a taxpayer on notice that the alternative minimum tax could apply if there was an early disposition of ISO stock. Taxpayers were entitled to rely on the legislative history of TEFRA and more recently on PLR 8713054 to believe that the Service would interpret the rules accordingly. There have been no legislative or regulatory pronouncements to the contrary until the provision in the Act. If the proposed change to § 57(a)(3) is retained and enacted into law, it should be effective on a prospective basis only, because it is certainly more than a technical correction. The change is a significant substantive change to the Code.

If you have any questions or comments regarding the contents of this letter, please do not hesitate to contact Ron Schrotenboer or the undersigned at (415) 494-0600.

Very truly yours,

Renee R. Deming

Renee R. Deming

F.W.WOOLWORTH CO.

EXECUTIVE OFFICE / WOOLWORTH BUILDING / NEW YORK, NY 10279 / TELEPHONE (212) 553-2056

HENRY C. MINER, III
VICE PRESIDENT

July 17, 1987

Mr. Robert J. Leonard, Chief Counsel
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Dear Mr. Leonard:

This letter is submitted in objection to a provision of the Technical Corrections Bill of 1987 (H.R. 2626), which makes various technical corrections to the Tax Reform Act of 1986.

Section 107(c)(4) of the Bill changes the treatment of incentive stock options (ISOS) for purposes of the alternative minimum tax. This provision would make the exercise of an ISO a tax preference item, even if the stock was not held for the required ISO holding period. This provision is a substantial change in existing law, rather than a "technical" correction in the 1986 Act changes.

Once the 1986 Act tax rates are fully effective, all income will be taxed at the same rates, and ISOs will not enable a holder to obtain a lower rate if the shares are held for one year after exercise (or 2 years after grant). The only benefit from an ISO is the ability to defer tax until the shares acquired on exercise are sold. This result is fair, since the shareholder does not realize the cash benefit until sale. If the shares acquired are sold shortly after exercise, even the deferral benefit is lost. In this event, it makes no sense to subject the "spread" on exercise of an ISO to a potential 21% alternative minimum tax when the shares acquired are not held for the required period. Section 107(c)(4) of the Bill should be deleted, since it is not simply a "technical" correction of the 1986 Act.

A more detailed analysis of the background of this issue is contained in the letter dated June 30, 1987 to Mr. Brockway which appeared in the July 13, 1987 issue of "Tax Notes". A copy of the letter is enclosed.

Respectively submitted,

Henry C. Miner, III

## CURRENT AND QUOTABLE

### Deming Criticizes Technical Correction Bill's Provision That Would Subject Exercise of ISO To Alternative Minimum Tax

*Set forth below is the full text of a June 30, 1987 letter to David H. Brockway, Chief of Staff of the Joint Committee on Taxation, from Renee R. Deming of Fenwick, Davis & West, Palo Alto, Calif. The letter also has been placed in the July 13, 1987 Tax Notes Microfiche Database as Doc 87-4216.*

Dear Sir:

The purpose of this letter is to comment on a provision of the Technical Corrections Act of 1987 (the "Act") which significantly alters the application of the alternative minimum tax to incentive stock options ("ISOs"). The provision would require an individual taxpayer to be subject to the alternative minimum tax on the exercise of an ISO even if he makes an early, or disqualifying, disposition of the ISO shares. This is a significant substantive change from current law; it is certainly more than a technical correction.

Section 107(c)(4) of the Act provides that subparagraph A of section 57(a)(3) of the Code is amended by striking out "section 422A" and inserting in lieu thereof "section 422A whether or not the holding period requirements of section 422A(a) are met." This proposed amendment to section 57 is troublesome as it is contrary to the intent of Congress which is expressed in the legislative history of the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA") which enacted section 57(a)(10) of the Code (section 57(a)(10) was redesignated section 57(a)(3) by the Tax Reform Act of 1986 ("TRA")) and a recent Private Letter Ruling issued by the Internal Revenue Service (the "Service"). There was no indication in TRA or the legislative history thereto that would have alerted taxpayers to this significant change in the minimum tax rules as they apply to ISOs. The proposed change becomes even more significant because of its apparent effective date.

The Economic Recovery Act of 1981 ("ERTA") established a new kind of stock option, an incentive stock option, under section 422A of the Code. Section 422A (a)(1) of the Code provides that section 421(a) shall apply with respect to the transfer of a share of stock to an employee pursuant to his exercise of an ISO if no disposition of such share is made by him within two years from the date of the granting of the option nor within one year after the transfer of such share to him. Pursuant to section 421(a), an employee who is granted a qualified ISO realizes no income upon the grant or exercise of the option. ERTA did not amend the tax preference provisions of section 57 of the Code at the time it created ISOs to include the difference between the ISO exercise price and the fair market value of the stock at the time of exercise (the "spread") as an item of tax preference for purposes of the minimum tax rules. Congress' decision to exclude the ISO spread from the list of tax preference items was particularly notable because of the prior law, specifically section 57(a)(6) of the Code, which treated the spread on the exercise of a restricted or qualified stock option, the predecessors to ISOs, as a tax preference item for purposes of the minimum tax.

Section 301 of the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA") amended section 57 of the Code in 1982 to include the ISO spread as an item of tax preference. In enacting section 57(a)(10), however, Congress specifically provided that "[i]t was not intended that the incentive stock option preference apply . . . where the special tax treatment for incentive stock options does not apply because there is an early disposition, as specified in section 422A(a)(1), of the stock acquired through the exercise of the option." See H.R. Rep. No. 97-760 (Conf. Rep.), 97th Cong. 2d Sess. 475 (1982), 1982-2 C.B. 600, 603.

Taxpayers have correctly interpreted the above-quoted language from the TEFRA Conference Report to mean that the imposition of the minimum tax is avoided by selling the purchased ISO shares within either two years from grant or one year from exercise of the ISO. Taxpayers have also taken the position that such early or "disqualifying" disposition avoids the minimum tax even if the sale takes place in a subsequent taxable year.

The regulations issued pursuant to section 57 of the Code, as it applied to qualified and restricted stock options, specifically addressed the inapplicability of the minimum tax rules in the event of an early disposition of the option stock. Regulation section 1.57-1(f)(5)(i) provided that section 57(a)(6) was inapplicable if during the same taxable year in which stock was transferred pursuant to the exercise of an option, the transferee made a disposition of the option stock.

The fact that the legislative history to section 57(a)(10) did not specifically restrict the inapplicability of the minimum tax rules to a disposition of ISO stock which occurred in the same taxable year as the exercise of the underlying option, as regulation section 1.57-1(f)(5)(i) had required for qualified and restricted stock options, is significant. Taxpayers have rightfully determined that an early disposition of ISO stock, even in a taxable year subsequent to the year of exercise, would render the minimum tax inapplicable to the ISO exercise. The Service recently confirmed this position in letter ruling, *LTR 8713054* (December 30, 1986).[1] Section 107(c)(4) of the Act directly contravenes this ruling.

Under the facts of *LTR 8713054*, an individual received ISOs from his employer to purchase shares of the corporation's stock. The employee exercised certain of the ISOs on June 16, 1986. The employee proposed to dispose of the ISO stock between January 1, 1987 and June 16, 1987. The employee requested a ruling as to whether the ISO spread would be a tax preference item under section 57(a)(10) of the Code in the year of exercise of the ISO.

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[1] While section 6110(j)(3) of the Code provides that private letter rulings may not be used or cited as precedent, such rulings do provide insight into the Service's position on certain issues. *LTR 8713054* is discussed herein for that purpose.

The ruling reviews the minimum tax rules of sections 55 and 57 of the Code as they apply to ISOs. It discusses the TEFRA provision which first applied the minimum tax rules to ISOs and it states that "[i]n enacting section 57(a)(10), Congress did not intend for the incentive stock option preference to apply where there is (sic) early disposition of the stock acquired through the exercise of the option."

***TRA did not amend in any way the basic rule of section 57(a)(10) that the ISO spread is an item of tax preference. The fact that the Act would now propose a significant change to that rule is difficult to accept and hardly qualifies as merely a technical correction.***

In the case presented, the individual intended to make an early or disqualifying disposition of the ISO stock in that he would sell the stock within one year of his exercise of the ISO. This would qualify as an early disposition under section 422A(a)(1) of the Code and would, therefore, preclude application of section 421(a) to the proposed transaction. The Service concludes in the ruling that section 57(a)(10) will not apply to the ISO spread upon the proposed disposition of stock, provided that the individual does in fact dispose of such stock between January 1, 1987 and June 16, 1987 (i.e., makes a disqualifying disposition).

TRA made two changes to section 57 and the minimum tax rules as they apply to ISOs. First, it redesignated section 57(a)(10) as section 57(a)(3). Second, it added section 57(a)(3)(B) which provides a basis adjustment in determining the amount of gain or loss on a subsequent sale of ISO shares for minimum tax purposes only. TRA did not amend in any way the basic rule of section 57(a)(10) that the ISO spread is an item of tax preference. The fact that the Act would now propose a significant change to that rule is difficult to accept and hardly qualifies as merely a technical correction.

The letter ruling was published after the enactment of TRA; the proposed transaction was to take place after the effective date of the changes made to section 57 by TRA. That the Service interpreted the TRA changes to section 57 to be irrelevant to this question is obvious. The Act would now reject this well-reasoned position without any justification.

An additional aspect of the proposed change to section 57(a)(3) which is troubling is its effective date. As currently drafted, section 107(c)(4) of the Act does not provide a specific effective date for the amendment contained therein. As a result, section 119 of the Act would appear to be applicable. Section 119 states that except as otherwise provided in the Act, any amendment made thereby "shall take effect as if included in the provision of the Reform Act to which such amendment relates." This would seem to make the change in the Act effective for tax years beginning after December 31, 1986, since the changes to section 57(a)(10) of the Code made by TRA are effective at that time. It would thus be retroactive to the beginning of 1987. This is extremely unfair particularly in light of the issuance of *LTR 8713054*.

There have been no indications in TRA or the legislative history thereto or since enactment of TRA which would have put a taxpayer on notice that the alternative minimum tax could apply if there was an early disposition of ISO stock. Taxpayers were entitled to rely on the legislative history of TEFRA and more recently on *LTR 8713054* to believe that the Service would interpret the rules accordingly. There have been no legislative or regulatory pronouncements to the contrary until the provision in the Act. If the proposed change to section 57(a)(3) is retained and enacted into law, it should be effective on a prospective basis only, because it is certainly more than a technical correction. The change is a significant substantive change to the Code.

Very truly yours,

Renee R. Deming
Fenwick, Davis & West

## CONGRESSIONAL HEARINGS

**FINANCE COMMITTEE SCHEDULES HEARINGS ON REVENUE OPTIONS TO REDUCE THE FEDERAL DEFICIT.** The Senate Finance Committee announced July 7 that it will hold three days of hearings to consider options for raising $19.3 billion in new revenues for fiscal year 1988, as called for by the recently passed budget resolution. The hearings are scheduled for July 15, 16, and 17, 1987. All three hearings will begin at 10:00 a.m. and be held in Room SD-215 of the Dirksen Senate Office Building. Formal requests to testify at the hearings should be sent to: Laura Wilcox, SD-205, Washington, D.C. 20515. All such requests must be received by the close of business on Friday, July 10, 1987. *Doc 87-4228*

**WAYS AND MEANS COMMITTEE ANNOUNCES ADDITIONAL HEARING ON REVENUE OPTIONS.** The House Ways and Means Committee has announced that it will hold an additional day of hearings to receive testimony from members of Congress on revenue-raising options. The hearing will take place on July 15 at 10:00 a.m. in Room 1100 of the Longworth House Office Building. Only members of Congress will be allowed to testify.

The full text of the Ways and Means hearing announcement has been placed in the July 13, 1987 *Tax Notes Microfiche Database* as *Doc 87-4211*.

**Schwartz & Freeman**

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July 30, 1987

Mr. David H. Brockway
Chief of Staff of the Joint
Committee on Taxation
1015 Longworth
Washington, D.C. 20515

Dear Sir:

The purpose of this letter is to comment on Section 107(c)(4) of the Technical Corrections Act of 1987 (the "Act"), which would require an individual taxpayer to be subject to the alternative minimum tax on the exercise of an incentive stock option ("ISO") even if the taxpayer makes a disqualifying disposition of the shares so acquired.

We are at a loss to understand why the early disposition of shares acquired under an ISO should be treated as a preference when the taxpayer does not achieve even a deferral of tax (let alone a lower tax rate). However, our immediate concern relates to the apparent effective date of the proposed "technical correction".

As noted in the letter to you dated June 30, 1987, from Renee R. Deming, Tax Notes 223 (July 13, 1987), Section 107(c)(4) of the Act does not provide for an effective date for the amendment to Code Section 57(a)(3)(A) contained therein. If, as a result, Section 119 of the Act applies to provide an effective date, the amendment to Code Section 57(a)(3)(A) would be effective for tax years beginning after December 31, 1986.

In one instance we are aware of, a corporation's shareholders, who had exercised their ISOs in 1987, negotiated for the sale of all their stock in the corporation with an acquiring corporation. The sale of their stock took place in 1987 and constituted an early disposition under Code Section

422(A)(a)(1). In making this sale the shareholders were much aware of the legislative history of Code Section 57(a)(10) (now Code Section 57(a)(3)), which stated that Congress did not intend for the incentive stock option tax preference to apply where the special tax treatment afforded ISOs does not apply because of an early disposition of the stock. See H. R. Rep. No. 97-760 (Conf. Rep.), 97th Cong. 2nd Sess. 475 (1982).

The shareholders recognized that the early disposition would result in the recognition of ordinary income to them and would also generate a corresponding deduction for the employer-corporation. The shareholders, in reliance on the legislative history referred to above, assumed that the ISO "spread" would not constitute an item of tax preference. The negotiations between the shareholders and the purchasers took all of these tax considerations into account and the deal struck by the two sides was clearly founded on such considerations.

It is manifestly unfair to retroactively amend a Code Section that has been relied upon in structuring and determining the nature of business transactions, particularly when the parties have had absolutely no notice that such a change was contemplated. Because the change proposed is substantive, if it is enacted, it should have a prospective effective date, rather than a retroactive effective date.

Very truly yours,

SCHWARTZ & FREEMAN

Joyce A. Levy

JAL:gp
cc: Robert J. Leonard ✓
    Renee R. Deming
    Daniel Rostenkowski

# COMMENTS BY
# OLIN CORPORATION
# ON TECHNICAL CORRECTIONS ACT OF 1987
# (H.R. 2636, S. 1350)

## WINCHESTER GUN COLLECTION

Olin Corporation ("Olin") is requesting transition relief from the provisions of the Tax Reform Act of 1986 which would adversely affect its ability to contribute appreciated property to the Buffalo Bill Memorial Association ("BBMA"). This is not a new issue. It is understood that commitments were made in 1986 to include a transition rule first in the Act and then in Con. Res. 395. For reasons which are not entirely clear, the rule was not included. Based on commitments which were given, we believe the rule may have been inadvertently omitted.

By way of background, Olin made a permanent loan of its Winchester Gun Collection (the "Collection") to the Buffalo Bill Memorial Association of Cody, Wyoming, pursuant to an agreement dated August 28, 1975. Supplemental agreements covering additional items were executed on February 24, 1982, and March 15, 1983. The agreements provide that Olin will transfer ownership of the Collection to BBMA at a future date in a manner most advantageous to the business and charitable purposes of Olin. Due to an ongoing program of substantial contributions to Science Park Development Corporation, a charitable organization, formed by Olin, Yale University and the City of New Haven, and certain other significant contributions, Olin has been unable to utilize all of its charitable contributions on a current basis. As a result, the contemplated contribution of the Collection has been delayed.

The Tax Reform Act of 1986 adversely impacts on Olin's ability to fulfill its stated intention of donating the Collection to BBMA. Specifically, it would treat the appreciated value of the Collection as an item of tax preference subject to the new corporate alternative minimum tax. Given competitive pressures and the resulting pricing constraints on capitalintensive companies, it is anticipated that Olin will be subject to the alternative minimum tax for the next several years. As a result, Olin would derive no tax benefit from a contribution of the Collection.

It should be noted that the Joint Committee on Taxation determined last year that the proposed transition relief would be revenue neutral. This determination was based on a letter from Olin's Chairman to Mr. David Brockway, of the Joint Committee on Taxation, wherein it was stated that absent transitional relief, Olin would indefinitely defer the donation of the Collection to BBMA.

Therefore, Olin is again requesting that transitional relief be provided. Suggested legislative language follows:

Olin Corporation

Proposed Statutory Language
For Alternative Minimum Tax
Transition Rule
For Certain Charitable Contributions

"Notwitnstanding any provision to the contrary, no alternative minimum tax shall be imposed by reason of any charitable contribution of property made pursuant to a loan and contribution agreement dated August 28, 1975, and supplemented by agreements dated February 24, 1982 and March 15, 1983.

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August 25, 1987

Robert J. Leonard, Esq.
Chief Counsel
Ways & Means Committee
1102 Longworth House
Office Building
Washington, D.C. 20515

Re: Technical Corrections Bill of 1987
Our File No. A0001.00033.130.1010

Dear Mr. Leonard:

We are writing this letter on behalf of our clients to make a comment on (i) the Tax Reform Act of 1986, Technical Corrections Bill of 1987, (ii) the changes to the Alternative Minimum Tax, and (iii) the inclusion of appreciated capital gain property as a tax preference after August 16, 1986. Therefore, we are enclosing six (6) copies of this letter for inclusion with the other public comments currently being considered on the Technical Corrections Bill of 1987.

Topic: Alternative Minimum Tax - Charitable Deduction of Appreciated Property - Internal Revenue Code Sec. 57 (a)(6).

Discussion:

The Tax Reform Act of 1986 [Sec. 701(a)] amended the Internal Revenue Code and added a new tax preference item arising from the deduction of a charitable contribution of appreciated property made after August 16, 1986. The preference portion of the charitable deduction is that part of the contribution which exceeds the taxpayer's tax basis in the property donated. Thus, in the case of appreciated property, a contribution to a charitable organization may result in the taxpayer being subjected to the Alternative Minimum Tax.

Since this is now the law for gifts made after the effective date of August 16, 1986, a taxpayer choosing to make a substantial gift to a charity after this date must take this tax consequence into consideration when making his decision. However, for the taxpayer who has previously made a binding commitment to a charity to make a gift after that date, it has created a non-planned and potentially devastating consequence which he is unable to avoid, even if he elects not to deduct the contribution when it is made. [See Internal Revenue Code, Sec. 63 (d); Forrester Box Company v. Commissioner, 123 F.2d 225 (8th Cir. 1941)].

The comment that we would like to make is to suggest that some provision be made for the taxpayer who has made a binding commitment to a charity prior to August 16, 1986. There should be an exclusion for such gifts so that philanthropic taxpayers are not penalized for honoring their pledges or commitments made before this change in the tax law. Surely, there can be no logical distinction for tax purposes between a "gift made" and a "gift committed to be made" before August 16, 1986.

Over the years, prior tax legislation has limited the amount of tax benefit a taxpayer could receive for contributions of appreciated property. Now we are again penalizing those taxpayers who have been willing to share their financial success with others and have made no provision for a taxpayer who has made a binding commitment to a charity prior to this major change in the tax treatment of charitable donations of appreciated property.

It is suggested that it was not the Legislature's intent to look to the "time" when the deduction is claimed, but rather when the taxpayer's "donative decision" was made. Section 701(f)(4) of the Tax Reform Act of 1986 (amending Section 57(a)(6) of the Internal Revenue Code) provides that the tax preference rules do not apply to the deduction of a charitable contribution after the effective date, if that deduction arises from the carry forward of a charitable contribution deduction attributable to a gift made before August 16, 1986. It is logical to assume that since the Legislature did not intend the tax preference rules apply to all charitable contribution deductions after August 16, 1986, its intent was to look to the time the donative decision was made.

However, as the statute presently reads, a taxpayer who made his donative decision and entered into a binding commitment prior to the effective date to donate appreciated property to a charitable organization in the future (which happens to be after August 16, 1986) will be subject to the new preference rules with no option available to him, since he is contractually bound to make the donation to the charity after August 16, 1986.

Many universities, hospitals and other charities have solicited donors for gifts of land, businesses and stock to aid in the charitable purposes of the organization. In many cases there are business and practical reasons for the taxpayer to retain ownership and possession of his property until a later date. Sometimes the property is an active trade or business, which the charity cannot operate and would have to sell at a distressed price to avoid management expenses. In other cases, the taxpayer may want to maintain the personal satisfaction of ownership until a later time; however, the charity can, and often does, obtain a binding commitment today to receive the donation in the future.

The Legislature has historically tried to protect taxpayers from dramatic changes in the law by providing grandfather clauses to certain items. An example under the elimination of the investment tax credits was the establishment of transitional rules under the Tax Reform Act of 1986 [Sec. 203(b) to (e)] for property constructed or purchased pursuant to binding written contracts before the date of the enactment of the legislation. More on the point are the provisions in the Alternative Minimum Tax under Internal Revenue Code Sec. 57(a)(6), discussed above, which eliminates the tax preference rules to charitable contribution deductions claimed after August 16, 1986, which arise due to donative decisions made prior to that date.

Both of these examples, and many others, are enactments to prevent taxpayers from suffering drastic changes in the tax laws where prior decisions of the taxpayer have been made.

Recommendation:

A provision should be added to the Technical Corrections Bill of 1987 to make an exception to the inclusion of itemized charitable deductions of appreciated capital gain property as a tax preference item under the Alternative Minimum Tax rules of Internal Revenue Code Sec. 57(a)(6), when a taxpayer makes a current donation of appreciated property under a written commitment or pledge entered into by the taxpayer and the charitable organization prior to August 16, 1986.

We would be pleased to discuss this recommendation with you, and will be available to answer any questions you might have.

Very truly yours,

PAGE & ADDISON, P.C.

Murry E. Page

COMMENTS OF
HENRY J. SPRING, JR. DIRECTOR-PUBLIC AFFAIRS, PITNEY BOWES INC.
U.S. HOUSE OF REPRESENTATIVES
COMMITTEE ON WAYS AND MEANS
RE: THE TECHNICAL CORRECTIONS ACT OF 1987, H.R. 2636
JULY 13, 1987

On behalf of Pitney Bowes Inc. (PBI), I appreciate this opportunity to present our comments in connection with the Technical Corrections Act of 1987, H.R. 2636. We believe that the Technical Corrections Act of 1987 is the appropriate legislative instrument to provide clarification of a certain provision of the Tax Reform Act of 1986 (Tax Reform Act). The provision at issue is the book income preference, Section 701 of the Tax Reform Act. PBI believes that the application of the book income preference, as it relates to PBI's internal transfers of equipment through intercompany sales for purposes of leasing to third parties, creates results which were unintended by Congress (as set forth in the General Explanation of the Tax Reform Act of 1986) and which are inappropriate and unfair under well-established principles of tax law.

## PBI's Business, Subsidiary and Methods of Accounting

In order that the application of the book income provision to PBI be understood, I would like to briefly describe PBI, its relationship with its subsidiary in question, and its methods of accounting.

PBI manufactures and markets in the United States various items of office and business equipment produced by its U.S. Business Systems Division, as well as those produced by other manufacturers. For the purposes of assisting in the marketing of these products, in 1977 PBI formed a wholly-owned subsidiary, now known as Pitney Bowes Credit Corporation (PBCC). PBCC is included in the Federal consolidated tax return filed by PBI. Where PBI's customers wish to lease, as opposed to purchased, PBI equipment, PBI internally transfers, through an intercompany sale, such equipment from its U.S. Business Systems division to PBCC. These intercompany sales by PBI to its wholly-owned subsidiary, PBCC, does not, in fact, represent a sale or transfer to an unrelated third party since, for consolidated tax purposes, PBI and PBCC are essentially one entity. The leases provided by PBCC cover either a 3-, 4-, or 5-year term. Pursuant to the lease provisions, the equipment must be returned by the lessee to PBCC at the end of the lease term. Alternatively, the lessee may elect to renew the lease or purchase the equipment at its fair market value. Therefore, under the basic terms of its true lease agreement, PBCC retains the risks and burdens inherent in ownership of the leased equipment. The arrangement that PBI has through its wholly-owned subsidiary, PBCC, is a rental of equipment to a third party, with no sale or transfer of title occurring outside the consolidated group (taxable entity).

In PBI's accounting for financial purposes, PBCC is treated as an unconsolidated subsidiary. In accordance with Generally Accepted Accounting Principles, PBI reports "sales" to PBCC in the year that the lease is executed. PBI includes in book income the entire income from the sale to PBCC reduced by its inventoried cost. On the separate accounting records of PBCC, the cost of the equipment to PBCC plus the finance charges inherent in the lease are included as a lease receivable.

In PBI's accounting for tax purposes, PBCC is included in the consolidated tax return of PBI. By consolidating PBI and PBCC for tax purposes, income is recognized as if only one entity exists for tax purposes. Under Regulations 1.1502-3, intercompany profit on the intercompany sale from PBI to its subsidiary, PBCC, for purposes of a subsequent lease to a third party, is treated as a non-taxable event for purposes of consolidated tax reporting. The intercompany profit to PBI is then recognized for tax purposes on the consolidated return as the asset is depreciated on the books of PBCC, thereby offsetting PBCC's depreciation claimed so that in consolidation, depreciation is actually based on PBI's cost of the equipment. Income from third parties is then recognized from from lease receipts. The consolidated return thereby reflects actual economic income being subject to tax in the year in which it is received or realized by the tax entity.

However, under the Tax Reform Act, Section 701, book income preference provision, intercompany sales (as distinguished from a sale to a third party), which are recognized as sales for book purposes, are subject to taxation, even though income from the intercompany transaction has not been received from sources outside the tax entity.

## Intent, and Application to PBI, of the Book Income Preference

In the General Explanation of the Tax Reform Act of 1986 (H.R. 3838, 99th Congress; Public Law 99-514), Title VII-Minimum Tax Provisions, Reasons for Changes, the Congressional intent of the book income preference provision may be summarized by the following excerpts:

> Congress concluded that the minimum tax should serve an overriding objective: to ensure that no taxpayer with substantial economic income can avoid significant tax liability by using exclusions, deductions, and credits. (Emphasis added.) p. 432
>
> In certain circumstances where income is defined more broadly for financial reporting purposes than for any tax purposes, Congress concluded that financial reporting definitions should apply, in order to prevent the avoidance of taxation by companies that report earnings to regulators, shareholders or creditors. (Emphasis added.) p. 435

The above passages demonstrate that the Congressional intent of the book income provision under the Alternative Minimum Tax provision was to focus on the situation where a tax entity has received economic income but through various tax mechanisms has effectively avoided taxation. The following is a discussion of why this provision is not applicable to the PBI tax entity based upon the Congressional intent of such provision, in that it has neither, in fact, avoided taxation nor deferred tax on real economic income from third parties.

The intercompany sale of equipment by PBI to its wholly-owned subsidiary, PBCC, for subsequent lease by PBCC to third parties, does not represent economic income or result in any economic significance to the tax entity. Income is recognized in any given year only when rentals are received or due PBCC from leases to third parties and is, therfore, fully reported on PBI's consolidated tax return. There is, in fact, no deferral or avoidance of any economic income received from any source outside the tax entity. PBI and PBCC's lease arrangements may be differentiated from other types of transactions which could more appropriately fulfill the intent of the book income provision. Those other transactions include the installment sales and the completed contract methods. Under the installment sales method, title passes to a third party immediately upon sale. Under the completed contract method, payments are made over a period of time, with title passing (or a sale taking place) to a third party automatically at the end of the contract term. In each of these other arrangements, a disposition or sale of an asset to a third party has occurred, whereas with the intercompany sale of equipment by PBI to PBCC for rental by PBCC under a true lease contract, no sale or disposition to a third party has occurred, and according to the contract, title remains with PBCC and, therefore, the asset remains within the consolidated group. Under the installment and completed contract methods, a clear intention exists from the outset that title and ownership shall pass as a part of the transaction. No such intention exists when PBCC rents its equipment to third parties. It may also be said that under the installment sales or completed contract methods, the income from such sales is deferred over the contract term. PBI and PBCC, as a consolidated taxpayer on the other hand, do not defer economic income but report subsequent true lease rental receipts from third parties in the year in which they are earned and/or received. Therefore, the PBI-PBCC lease arrangement is not the intended target of the book income provision (as set forth in the foregoing General Explanation excerpts), as this arrangement does not avoid taxes by deferring recognition of future rental receipts.

Another stated intention of the book income provision was to correct the harm caused to "the perception and reality of fairness." While concern for public perception is a laudable objective, PBI respectfully disagrees with this objective being used as a basis for taxation where it results in unfairness to PBI, under the circumstances above explained. We believe that the application of the book income provision, like any other provision of the tax code, should insure that in any tax year, economic income received by the taxpayer should be subject to tax in that year, and that taxation should not occur at an earlier time. The PBI tax entity pays taxes on income as it is received from sources outside the consolidated tax entity. Generally Accepted Accounting Principles, which treat the intercompany sale of equipment within the tax entity as a sale, have different objectives than the tax code. Consequently, the PBI tax entity, by adhering to those mandatory accounting principles, is, in effect penalized for tax purposes.

In summary, given the nature of the transactions of PBI at issue (intercompany sales within the PBI consolidated tax entity for subsequent lease and not sale to third parties) and the stated intention of Congress under the book income provision above set forth, PBI believes that such provision is technically in error when applied to the intercompany transactions within the PBI tax entity which are recognized as sales for book purposes. This provision should be corrected or book income defined so as to avoid an unintended tax being levied on a transaction which results in no economic significance to the tax entity or where there is no real economic income received from third parties. Defining book income so that it includes income from transactions where possession of goods or equipment passes to an unrelated party only upon the earlier of the time when title passes or cash payments are received or due, Congressional intent may be more accurately reflected.

Again, I appreciate this opportunity to present PBI's comments and will provide any other information the Committee may deem helpful.

## PROPOSED CLARIFICATION TO CORPORATE ALTERNATIVE MINIMUM TAX

Section 701(a) of the Tax Reform Act of 1986 amends Part VI of subchapter A of chapter 1 of the Internal Revenue Code (IRC) to impose an alternative minimum tax (AMT) for individuals and corporations. As amended, IRC section 56(g) provides that the alternative minimum taxable income (AMTI) of any corporation for any taxable year beginning after 1989 shall be adjusted based on "adjusted current earnings."

Pursuant to IRC section 56(g)(3), the term "adjusted current earnings" means:

> "the AMTI for the taxable year --
>
> (A) determined with the adjustments provided in paragraph (4), and
>
> (B) determined without regard to this subsection and the alternative tax net operating loss deduction."

IRC section 56(g)(4) provides a number of adjustments in determining adjusted current earnings. Included among those adjustments is IRC section 56(g)(4)(A)(i), which states (emphasis added):

> "PROPERTY PLACED IN SERVICE AFTER 1989. -- The depreciation deduction with respect to any property placed in service in a taxable year beginning after 1989 shall be determined under whichever of the following methods yields deductions with a smaller present value:
>
> (I) The alternative system of section 168(g), or
>
> (II) **The method used for book purposes.**"

In addition, IRC section 56(g)(4)(A)(v) states (emphasis added):

> "(v) SLOWER METHOD USED IF USED FOR BOOK PURPOSES. -- In the case of any property to which clause (ii), (iii), or (iv) applies, if the depreciation method used for book purposes yields deductions for taxable years beginning after 1989 with a smaller present value than the method which would otherwise be used under such clause, **the method used for book purposes shall be used in lieu of the method which would otherwise be used under such clause.**

The statute does not address the situation of a lessor who for financial statement purposes is required by Financial Accounting Standard Number 13 (FAS 13) to account for leases as direct-financing leases, but for tax purposes, properly accounts for leases as operating leases. Pursuant to FAS 13, no depreciation per se is deducted for financial purposes, while for tax purposes depreciation is deducted.

The language of IRC section 56(g)(4)(A) could be interpreted to say that since no depreciation is deducted for book purposes, no depreciation deduction would be allowed for AMT purposes in the above situation. It should be noted that this interpretation would apply regardless of when the asset was placed in service; i.e., it would be applicable for taxable years beginning after 1989 for assets placed in service both before or after 1989.

It also could be interpreted that since there is no depreciation method for book purposes, IRC sections 56(g)(4)(A)(i)(II) and 56(g)(4)(A)(v) are not applicable. If so, other provisions within IRC section 56(g)(4)(A) would apply. For example, pursuant to IRC section 56(g)(4)(A)(i)(I), property placed in service after 1989 would be depreciated under the alternative system of IRC section 168(g) if the book method is not applicable. Finally, it could be interpreted that although the FAS 13 accounting for direct-finance leases does not result in a depreciation deduction per se, the asset is effectively written down by operation of the required journal entries, and therefore, a "deemed" depreciation should be allowed.

Briefly, under the direct financing method, FAS 13 requires the lessor to substitute a "lease receivable" for the leased asset. The amount of the "lease receivable" is the sum of the lease payments receivable over the term of the lease, plus the estimated residual value of the leased asset.

The difference between the "lease receivable" and the cost or carrying value of the property is recorded as unearned income. As lease payments are received, the lease receivable is written down and the unearned income is amortized to income.

Upon expiration of the lease, the lease receivable would be written down to the estimated residual value and the unearned income would be fully written off. Thus, although the lessor records no depreciation expense, the asset is effectively written down from its original cost or carrying value to its residual value. One could argue that this represents a depreciation method.

For the reasons stated above, a clarification is needed to provide a rule applicable to financing lease transactions for purposes of permitting taxpayers to calculate depreciation under the adjusted current earnings rule. We believe that there are several options available to you for providing a technical correction.

**Option 1**: Indicate that IRC sections 56(g)(A)(4)(i)(II) and 56(g)(4)(A)(v) are not applicable to finance lease transactions that for financial statement purposes are required to be accounted for pursuant to FAS 13.

**Option 2**: Provide for "deemed depreciation" based on the difference between the taxpayer's cost or carrying value and the estimated residual value of the leased asset. Such amount could then be "depreciated" using any acceptable method (e.g., straight-line) over the lease term.

**Option 3**: Provide for a "deemed depreciation" based upon what depreciation would have been if, for financial statement purposes, the taxpayer accounted for the lease as an operating lease.

**Option 4**: Indicate that in situations which, for financial statement purposes, the taxpayer accounts for finance leases pursuant to FAS 13, the Treasury should by regulation or other administrative action provide for an appropriate deemed depreciation. In no event, however, should the amount of depreciation over the term of the lease be zero.

We believe that Option 1 is the easiest to administer since no additional calculations would be required by the taxpayer. Options 2 and 3 are viable alternatives but would require additional computations. Waiting for regulations would be extremely undesirable given the backlog of current regulations projects but a solution that would permit the issuance of a ruling would be acceptable.

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# COMMENTS OF THE STOCK COMPANY INFORMATION GROUP
# TO THE COMMITTEE ON WAYS AND MEANS OF THE
# UNITED STATES HOUSE OF REPRESENTATIVES
# CONCERNING H.R. 2636,
# THE TECHNICAL CORRECTIONS ACT OF 1987

The Stock Company Information Group appreciates this opportunity to submit comments to the Committee on Ways and Means with respect to H.R. 2636, the Technical Corrections Act of 1987. The Stock Company Information Group (the "SIG") consists of 28 investor-owned life insurance companies. Taking into account its members' affiliated companies, the SIG includes a majority of the 50 largest life insurance companies in the United States. The SIG was organized in 1981 to monitor tax legislative developments and to convey the views of its membership on life insurance tax issues to the various insurance trade associations and to the Government. The SIG has been privileged to work closely with the Committee and its staff in connection with the development of the insurance tax provisions of the Tax Equity and Fiscal responsibility Act of 1982, the Deficit Reduction Act of 1984 (the "1984 Act"), and the Tax Reform Act of 1986 (the "1986 Act"). A list of the SIG member companies appears at the end of this statement.

## I. Introduction.

Our comments are limited to several aspects of the new corporate alternative minimum tax ("AMT") which are of concern to stock life insurance companies. Under the AMT, a corporation's alternative minimum taxable income ("AMTI") will be adjusted to include a portion of what have been characterized as "business untaxed reported profits." In 1987, 1988, and 1989, this adjustment will be based on "net book income," while in 1990 and ensuing years the adjustment will be based on "adjusted current earnings." The problems we see under these adjustments are as follows:

(1) All mutual life insurance companies (and some stock companies) will use their annual statement gain or loss from operations in determining the amount (if any) of the book income adjustment, while many stock life insurance companies will determine that amount from a GAAP financial statement, which typically will show a larger amount of "book income."

(2) Under both the book income and the current earnings adjustment, the small life insurance company deduction is in effect treated as a preference item, i.e., a small life insurance company otherwise eligible for the effective rate reduction granted by the small company deduction is denied the benefit of that reduction through the AMT.

(3) During the years 1987-89, mutual life insurance companies will receive a greater deduction for policyholder dividends in computing AMTI than they will receive in computing regular taxable income and in computing adjusted current earnings in 1990 and thereafter.

In order to correct these problems, the Stock Company Information Group recommends that the following three changes be made in the AMT:

(1) Book income should be defined, in the case of

all life insurance companies, as annual statement gain or loss from operations (before Federal income tax).

(2) The small life insurance company deduction should not be treated as a preference item. Specifically, book income or current earnings, as the case may be, should be reduced by the amount of the small company deduction allowed in determining a company's regular taxable income.

(3) In computing book income under the AMT, a mutual life insurance company should be allowed to deduct only those policyholder dividends which are deductible in computing regular taxable income.

A discussion of each of these problems and recommendations follows.

## II. The "book income" of life insurance companies should be measured by annual statement accounting.

### A. Background

### 1. Regular Taxable Income

In determining the regular taxable income of a life insurance company, the Code generally uses the figures reported by the company on the annual statement the company must file with State insurance regulators. This statement follows the form prescribed by the National Association of Insurance Commissioners to carry out the accounting requirements imposed on insurers by State statutes and regulations; hence the oft-used reference to annual statement accounting as "statutory" accounting. In instances where the tax rules require a departure from the annual statement figures, as in the case of life insurance reserves under section 807(d), the figures specially computed for tax purposes are derived from annual statement data.

Thus, annual statement accounting is the touchstone for tax accounting. Indeed, mutual life insurers and some stock life insurers have no formal financial report other than the annual statement. On the other hand, many stock life insurers (including the largest stock life insurers) prepare audited GAAP financial statements, either for purposes of SEC filings or for other purposes.

In formulating the life insurance company provisions of the 1984 Act, Congress paid considerable attention to the effect that those provisions would have on competition between mutual and stock companies. As part of the 1984 law, Congress allocated 55 percent of the life insurance industry's tax for the year 1984 to mutual companies and the remainder to stock companies. (I.R.C. section 809 contains a mechanism for reallocation in subsequent years.)

### 2. The Alternative Minimum Tax

Under the book income adjustment, a life insurance company's AMTI will be increased by one-half of the excess (if any) of the company's "book income" over the company's "pre-book alternative taxable income" (generally, its regular taxable income plus any other enumerated preference items). The company's "book income" is the net income shown on its "applicable financial statement." A life insurance company's applicable financial statement will be either a financial statement filed with the SEC, or if it has no such statement, a certified audited GAAP financial statement, or if it has neither of the foregoing, the NAIC annual statement filed with State regulators.

## B. The Problem under the Alternative Minimum Tax

The "book income" adjustment does not treat stock and mutual life insurance companies equally, i.e., the AMT is not a level playing field. As noted above, many stock life insurance companies prepare GAAP income statements, but no mutual life insurers do (other than for internal analytical purposes). Thus, all mutual life insurance companies (and some stock companies) will use their annual statement gain or loss from operations in determining the amount (if any) of the book income adjustment, while many stock life insurance companies will determine that amount from a GAAP financial statement. The differences between a life insurance company financial statement prepared in accordance with generally accepted accounting principles and one prepared in accordance with statutory accounting principles frequently are substantial, with a GAAP statement typically showing a larger amount of "book income." These differences could give mutual life insurance companies a competitive advantage over many stock life insurance companies.

## C. Recommendation

In order to treat all life insurance companies equally under the AMT during the years 1987, 1988, and 1989, book income should be defined for all life insurance companies as annual statement gain or loss from operations (before Federal income tax). A suggested amendment appears at the end of this statement.

## D. Discussion

Just as annual statement accounting has long been the basis for determining the tax liability of life insurers, it should also be of primary relevance in any minimum tax computation. In contrast to other industries where there may be no single, common method of computing book income, the life insurance industry has a nationally uniform set of non-tax books -- the annual statement filed with State regulators. Treating the annual statement gain from operations of life insurers as their exclusive book income will help to ensure an even-handed application of the AMT industry-wide. It would also accord with the 1986 resolution of the National Association of Insurance Commissioners urging Congress to require the use of statutory insurance accounting principles (i.e., the annual statement) in any book income preference computation.

Uniformity aside, as recently as 1984 Congress thoroughly reviewed the tax treatment of life insurance companies, including the long-standing practice of the tax law to make use of annual statement data as the basis of tax computations. Rather than depart from the use of the annual statement, Congress reaffirmed it as the source of the tax computations. Although other types of earnings statements were known to Congress at that time, they were not employed for the following reasons: (1) a significant number of life insurance companies (including the three largest life insurance companies in the Nation) do not have any financial statement other than the annual statement; and (2) other financial statements will show differences from the annual statement primarily in timing rather than in "permanent" items. These reasons are equally persuasive as to why the annual statement should be used in the AMT.

**In sum, to preserve the well considered decisions made by Congress in enacting the life insurance company provisions of the 1984 law, and to ensure a level playing field between segments of the industry, the annual statements that all life insurance companies file with their State regulators (and which are audited by those regulators) should provide the exclusive basis for determining the book income of such companies.**

## III. The benefit of the small life insurance company deduction should not be reduced by the alternative minimum tax rules

### A. Background

Under section 806, qualifying small life insurance companies may claim the benefit of the "small life insurance company deduction" in computing their regular taxable income. This deduction, enacted as part of the 1984 life insurance tax legislation in place of similar rules under prior law, was intended to reduce the tax rates applicable to eligible small companies. As noted in the House and Senate Reports accompanying the 1984 Act, the small life insurance company deduction results "in effect in a lowering of the tax rates on LICTI" (life insurance company taxable income). See H.R. Rep. No. 432, Pt. 2, 98th Cong., 2d Sess. 1404 (1984); S. Prt. No. 169, Vol. 1, 98th Cong., 2d Sess. 528 (1984).

### B. The Problem Under the Alternative Minimum Tax

Under both the book income and the current earnings adjustments, the small company deduction is in effect treated as a preference item, i.e., a small life insurance company otherwise eligible for the rate reduction granted by the small company deduction is denied the benefit of that rate reduction under the AMT.

### C. Recommendation

The small life insurance company deduction should not be treated as a preference item. Specifically, the AMT should be amended to provide that adjusted current earnings or book income, as the case may be, are to be reduced by the amount of the small company deduction allowed in determining the company's regular taxable income. A suggested amendment appears at the end of this statement.

### D. Discussion

Because the amount of the small company deduction is a percentage of an eligible company's otherwise taxable income, the deduction can only reduce the company's tax rate. It cannot produce a loss. The policy behind this deduction has been reaffirmed by its retention by the Tax Reform Act of 1986, which specifically rejected the President's proposal to repeal the deduction.

The 1986 Act, moreover, does not treat other instances of rate relief (such as the graduated rates for smaller corporations) as a preference item subject to the minimum tax. Since the small life insurance company deduction functions in the same way -- rate relief for small life insurance companies -- it, too, should not be treated as a preference item.

## IV. Mutual life insurance company policyholder dividends should not be fully deductible for purposes of the book income adjustment

### A. Background

For more than sixty years Congress has, directly or indirectly, but without exception, limited the extent to which policyholder dividends paid by a mutual life insurance company can be deducted in computing the company's regular taxable income. Currently, in computing taxable income under subchapter L of chapter 1 of the Code, a portion of the policyholder dividends paid by a mutual life insurance company is explicitly disallowed as a deduction. The amount disallowed is determined under I.R.C. section 809.

The limit on dividend deductibility fixed by section 809 is an integral part of the comprehensive 1984 revisions to the taxation of life insurance companies. The section 809 limit was adopted only after extended consideration. In enacting this limit, Congress recognized that part of a mutual life insurance company's policyholder dividends represents a price rebate to its customers and should be deductible in computing corporate-level income. Part, however, is a distribution of corporate income to the corporation's owners (similar to dividends to shareholders), and like other distributions of corporate income should not be deductible in computing taxable income. The limitation determined under section 809 was intended by Congress to measure this nondeductible corporate income element. *See* H.R. Rep. No. 432, Pt. 2, *supra*, at 1422; S. Prt. No. 169, Vol. I, *supra*, at 547-49.

The section 809 limitation on a mutual life insurance company's policyholder dividend deduction is equally applicable in determining adjusted current earnings. As explained in the Joint Committee's *General Explanation of the Tax Reform Act of 1986* (at pages 457-58):

> In general, adjusted current earnings requires the same treatment of an item as used for purposes of computing unadjusted alternative minimum taxable income. Thus, for example, deduction disallowances or limitations that apply for purposes of determining regular taxable income and alternative minimum taxable income also apply for purposes of determining adjusted current earnings (e.g., the disallowance of a deduction for bribes and kickbacks (sec. 162(c)) or for penalties (sec. 162(f)), and and the limitation on the deduction for policyholder dividends (sec. 808(c)(2)).

### B. The Problem under the Book Income Adjustment

The striking anomaly that has arisen under the book income adjustment is that policyholder dividends of a mutual life insurance company, which are not fully deductible in computing regular taxable income, or in computing adjusted current earnings, nevertheless appear to be fully deductible in computing the book income adjustment.

Under the "book income" adjustment, a life insurance company's AMTI will be increased by one-half of the excess (if any) of the company's "book income" as shown on its "applicable financial statement" over its "pre-book alternative taxable income" (generally, its regular taxable income plus any other enumerated preference items). The applicable financial statement, in the case of a mutual life insurance company, is the company's NAIC annual statement which it files with state insurance departments. Thus, a mutual life insurance company's "book income" adjustment will be based on gain or loss from operations as reported on its annual statement. The annual statement, however, contains two potentially relevant statements of income: gain or loss from operations without a deduction for policyholder dividends, and gain or loss from operations with a deduction for policyholder dividends.

The statute (in section 56(f)) does not specify the use of either of these measures of income, nor does it give any indication of the extent to which policyholder dividends are to be taken into account in computing the adjusted net book income of a mutual life insurance company. The Conference Report accompanying the 1986 Act states, however, that "the conferees intend that the measure of pre-tax book income is the amount of net gain from operations after dividends to policyholders and before Federal income taxes." See H.R. Rep. No. 841, vol. II, 99th Cong., 2d Sess. 273 (1986).

## C. Recommendation

The AMT should be amended to provide that in computing book income, a mutual life insurance company should be allowed to deduct only those policyholder dividends which are deductible in computing regular taxable income. A suggested amendment appears at the end of this statement.

## D. Discussion

There are a number of sound policy reasons why a mutual life insurance company's deduction for policyholder dividends should be limited under the book income adjustment of the AMT in exactly the same way as that deduction is limited in computing regular taxable income and in computing adjusted cuurent earnings:

- Section 809 is the Congress's most current, and most carefully considered, assessment of the extent to which the deductibility of policyholder dividends should be limited for purposes of the regular corporate tax. That limitation will be in effect under the minimum tax starting in 1990. No basis exists for allowing a greater deduction for purposes of the minimum tax during the years 1987-89.

- Section 809 identifies that portion of a mutual life insurance company's policyholder dividends which should be treated as deductible rebates to customers and that portion which should be treated as nondeductible distributions of corporate income to the owners of the corporation. Other corporations cannot deduct dividends to owners in measuring their business untaxed reported profits, and mutual life insurance companies should not be treated more favorably than other corporations.

- If mutual life insurance companies are allowed an additional deduction for policyholder dividends in computing book income, it will probably be the only instance in which a taxpayer receives more favorable treatment under the minimum tax than under the regular tax. Moreover, it would virtually exempt many mutual life insurance companies from the alternative minimum tax. Such results would be contrary to the basic purpose of Congress in enacting a more stringent

AMT.

## V. Conclusion

In summary, the Stock Company Information Group recommends that the AMT be amended to provide that:

(1) In the case of all life insurance companies, book income is defined as annual statement gain or loss from operations (before Federal income tax).

(2) The small life insurance company deduction is not treated as a preference item.

(3) In computing book income, a mutual life insurance company may deduct only those policyholder dividends which are deductible in computing regular taxable income.

* * *

The member companies of the SIG thank the Committee on Ways and Means for the opportunity to comment on these matters.

Respectfully submitted,

DAVIS & HARMAN

By: William B. Harman, Jr.
William B. Harman, Jr.

On behalf of the Stock Company
Information Group

July 17, 1987

## MEMBERS OF THE STOCK COMPANY INFORMATION GROUP

Aetna Life & Casualty Company
Allstate Life Insurance Company
American General Corporation
Business Men's Assurance Company of America
Capital Holding Corporation
CNA Insurance Company
CIGNA Corporation
Federal Kemper Life Assurance Company
Federal Home Life Insurance Company
Franklin Life Insurance Company
Hartford Life Insurance Company
E.F. Hutton Life Insurance Company
ICH Corporation
IDS Life Insurance Company
Integon Life Insurance Corporation
Jefferson-Pilot Life Insurance Company
Monarch Capital Corporation
Liberty Life Insurance Company
Life Insurance Company of Georgia
Life Insurance Company of Virginia
Lincoln National Life Insurance Company
Paul Revere Life Insurance Company
Provident Life and Accident Insurance Company
Torchmark Corporation
Transamerica Occidental Life Insurance Company
Travelers Insurance Company
UNUM Corporation
Washington National Insurance Company

## Suggested Statutory Language

### Measuring the "Book Income" of Life Insurance Companies by Annual Statement Accounting

To measure the "book income" of all life insurance companies by reference to the annual statement filed with state insurance regulators, the following sentence could be added to I.R.C. section 56(f)(3)(C).

> "For purposes of subparagraph (A), in the case of a life insurance company, the applicable financial statement shall be the annual statement within the meaning of section 809(g)(4)."

### Treatment of the Small Company Deduction under the Alternative Minimum Tax

There are two alternative methods of ending the treatment of the small life insurance company deduction as a preference item in the alternative minimum tax. First, either net book income or adjusted current earnings, as the case may be, can be reduced by the amount of the small company deduction allowed in determining the company's taxable income. This result would be achieved by the following amendments:

#### Method I

(1) Add to I.R.C. section 56(f)(2) the following new subparagraph:

> "ADJUSTMENT FOR CERTAIN SMALL LIFE INSURANCE COMPANIES. -- In the case of a life insurance company, adjusted net book income shall be reduced by the amount (if any) of the small life insurance company deduction allowable under section 806."

(2) Add to I.R.C. section 56(g)(4) the following new subparagraph:

> "ADJUSTMENT FOR CERTAIN SMALL LIFE INSURANCE COMPANIES. -- In the case of a life insurance company, a deduction shall be allowed equal to the amount (if any) of the small life insurance company deduction allowable under section 806."

#### Method II

Alternatively, a life insurance company's alternative minimum taxable income could be determined without regard to the small life insurance company deduction. This result would be achieved by the following amendments:

(1) Add to I.R.C. section 56(f)(1)(B), after "deduction":

> "and determined without regard to the amount (if any) of the small life insurance

> company deduction allowable under section 806."

(2) Add to I.R.C. section 56(g)(1)(B), after "deduction":

> "and determined without regard to the amount (if any) of the small life insurance company deduction allowable under section 806."

## Deductibility of Mutual Life Insurance Company Policyholder Dividends

To limit the deductibility of mutual life insurance company policyholder dividends in computing book income, the following subparagraph could be added to I.R.C. section 56(f)(2):

> "TREATMENT OF MUTUAL LIFE INSURANCE COMPANY POLICYHOLDER DIVIDENDS.-- In the case of a mutual life insurance company, in determining adjusted net book income a deduction shall be allowed for policyholder dividends paid or accrued during the taxable year equal to the amount of the deduction allowed in computing life insurance company taxable income under section 801(b)."

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July 14, 1987

Mr. Robert Leonard
Chief Counsel
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Re: Technical Corrections Act of 1986
Alternative Minimum Tax

Dear Mr. Leonard:

This letter discusses technical corrections to Title VII of the Tax Reform Act of 1986, pertaining to the alternative minimum tax.

A. It should be clarified that provisions of Code sections 56(a)(2)(B) and 56(b)(2)(B), allowing losses on disposition of certain property, apply even if there is a gain under the regular tax, as long as there is a loss for minimum tax purposes.

B. Code section 56(b)(2)(A) provides that the circulation and research and experimental expenditures adjustment applies to amounts paid or incurred after December 31, 1986. Section 801(f)(1) of the Act provides that the amendments apply to taxable years beginning after 1986. It is not clear whether a fiscal year taxpayer may use the adjustment concept for amounts paid or incurred after 1986 but in a taxable year beginning before 1987.

C. The General Explanation states, at page 447, that net income from passive farming activities can be offset for minimum tax purposes under the general passive loss rule against passive losses that are not from farming activities. However, not all passive farming activities are passive activities. It should be clarified that an offset is permitted only if the passive farming activity is a passive activity.

D. The heading for clause (i) of section 56(a)(1)(A), "Property other than certain real property," is somewhat misleading, since the clause gives the rule that generally applies to real property and some personal property. Perhaps the intended heading was "Property other than certain personal property."

E. The transition rule requiring corporations to reduce NOLs by the amount of deferred preferences on which no tax has been paid should apply to NOLs of individuals for loss years before 1983. See Act section 701(f)(2). Recall that pre-1983 NOLs of individuals were subject to the corporate minimum tax provision for the years 1983 through 1986. See TEFRA section 201(d)(2).

F. The preference for incentive stock options applies in the year the stock is transferred, not the year the option is exercised (which may be an earlier year -- see Reg. section 1.421-7(f) & (g). It would seem that the basis adjustment of Code section 57(a)(3)(B) should apply to "stock acquired (in a taxable year beginning after December 31, 1986) pursuant to an exercise of an incentive stock option" rather that to "stock acquired pursuant to an exercise (in a taxable year beginning after December 31, 1986) of an incentive stock option." Incidentally, a similar mistake appears in section 421(b) of the Code, referring to income or deduction for the taxable year in which exercise of an option occurs rather than in the year the transfer occurs.

G. The basis adjustment of Code section 57(a)(3)(B) applies only in determining gain or loss on a disposition of stock acquired through exercise of an ISO. This is in contrast with the basis adjustment provision of Code section 56(a)(7), which has general application in determining AMTI. There is no reason to restrict the ISO basis adjustment in this manner. For example, a taxpayer making a charitable contribution of ISO stock should be able to use a basis reflecting the ISO preference in determining the charitable contribution preference.

Very truly yours,

Kaye A. Thomas

KAT/lsi

NRECA NATIONAL RURAL ELECTRIC COOPERATIVE ASSOCIATION
1800 Massachusetts Avenue, N.W., Washington, D.C. 20036
Telephone: (202) 857-9500

July 17, 1987

Honorable Dan Rostenkowski, Chairman
Ways and Means Committee
1102 Longworth House Office
  Building
Washington, D. C.  20515

Dear Mr. Chairman:

On behalf of the National Rural Electric Cooperative Association, I am submitting these comments for the Committee on Ways & Means' consideration of H.R. 2636, the Technical Corrections Act of 1987. NRECA is the national service organization of more than 1000 member-owned cooperative systems providing central station electricity to 25 million Americans throughout seventy-percent of the U.S. land area in 46 states.

In the Tax Reform Act of 1986, Section 701(f)(2)(E) provided a "special rule for cooperatives" permitting Subchapter T cooperatives to reduce the amount of income subject to the corporate minimum tax by their patronage dividends. On behalf of NRECA, I would like to recommend similar treatment for our rural electric cooperative members.

Rural electric and telephone cooperatives operate on a similar not-for-profit cooperative basis like Subchapter T farmer cooperatives, however, we are specifically excluded from Subchapter T. Section 1381 (a)(2)(C) excludes any organization "which is engaged in furnishing electric energy, or providing telephone service to persons in rural areas." Rural electric and telephone cooperatives are treated in one of two ways in the tax code: either as tax-exempt under Section 501(c)(12), or, failing the 85% member-income requirement of 501(c)(12), as a nonexempt cooperative subject to tax.

Most rural electric cooperatives are tax-exempt under Section 510(c)(12), however, power generating cooperatives that engage in power sale arrangements with nonmember utilities may fail the 85% member income requirement. These cooperatives then fall into the nonexempt category. These nonexempt cooperatives continue to operate as nonprofit entities; it is for these cooperatives that we ask their inclusion in Section 701(f)(2)(E).

These power generating cooperatives are comprised of distribution cooperatives which join together for their power supply requirements. The distribution cooperatives pay monthly for their power needs. At the end of the year, that income which is not used to meet expenses and other operational cost is allocated back to the member cooperatives.

The patronage allocations are a return of the members' capital. Under current law and court interpretation, patronage allocations are treated as an exclusion for the gross income of the cooperative if such allocations are made pursuant to pre-existing obligations to allocate.

NRECA believes that in the true meaning of cooperative form of business, one cannot tax the patronage allocations to the cooperative's members. It is for this reason that we recommend that a second section be added to Section 701(f)(2)(E) which states:

> Any corporation operated on a cooperative basis as described in Section 1381(a)(2)(C) may elect to treat any allocation which is in the nature of a patronage dividend as a reduction in determining the corporation's adjusted net book income.

We thank the Committee for its favorable consideration.

Sincerely,

Bob Bergland

Bob Bergland
Executive Vice President

BB:vs

## Section 701 & 702

## CORPORATE ALTERNATIVE MINIMUM TAX

### Book Income Adjustment

### Technical Correction to Provide Limited Adjustment for Bad Debt Reserves of Commercial Banks

[Tax Reform Act §§701, 702 & 901; Code §§56(f) & 53]

### Background

The Tax Reform Act of 1986 ("Act") repealed the prior add-on minimum tax on corporations and created a new alternative minimum tax ("AMT") at a rate of 20 percent. The tax base for the corporate AMT consists generally of regular taxable income increased by the taxpayer's tax preferences and adjustments to negate accelerated deductions, and reduced by the exemption amount. A new item included in the AMT base as a preference for corporations for tax years beginning in 1987, 1988, and 1989 is the adjustment for book income. In general, a corporate taxpayer is required to increase its alternative minimum taxable income ("AMTI") by one-half of the difference between the adjusted net income it reports for financial statement purposes and its AMTI before this adjustment. After 1989, the book income adjustment is to be replaced by a new, broader measure of business profits more precisely defined and tied to tax earnings and profits -- "adjusted current earnings."

As under prior law, the Act provides a credit in the amount of the minimum tax paid that may be used to offset regular tax liability (but not below minimum tax liability) in future taxable years. Only the minimum tax attributable to timing differences between book and tax income ("deferral preferences" as opposed to "exclusion preferences") can be carried forward in this manner. This type of timing difference arises when a tax deduction occurs in advance of the book deduction, such as in the case of accelerated depreciation for tax purposes. The effect of such tax preferences is to defer taxable income (and thus regular tax liability) to a future year. The AMT credit corrects for this timing difference and prevents double taxation by allowing a minimum tax paid to offset regular tax liability in future years. The Act treats the book income adjustment as a deferral preference for this purpose.

The Act also repealed the deduction for bad debt reserves for most taxpayers and in so doing created a new type of timing difference. Taxpayers must now generally account for bad debt losses using the specific charge-off method for tax purposes -- i.e. taking a deduction when a debt is actually written off -- even if they maintain bad debt reserves for financial accounting purposes. Thus, the repeal of the tax bad debt reserve has the opposite effect of a deferral preference. A deferral preference defers taxable income, and hence regular taxes, to future years. Use of a reserve for book but not tax purposes postpones book income and consequently accelerates taxable income and regular tax. This "reverse" timing difference has been incorporated into the minimum tax through the book income adjustment, with the result that a taxpayer may be subject to minimum tax liability with respect to income that has already been subject to tax, in the subsequent taxable year in which the bad debt deduction is allowed for tax purposes.

The amount of double tax liability that will result from this reverse timing difference will be very substantial in the case of banks that have made extraordinary additions to bad debt reserves in 1987 to account for expected losses on loans made in the less developed countries. Such additions will reduce 1987 book income below the level of AMTI. To the extent this occurs, under present law banks will, in effect, lose their loan loss deduction from book income because no effect is given to a negative book income adjustment. Consequently, unless a mechanism is provided to carry such a negative adjustment forward, a double tax will occur in 1988 and 1989 when a corresponding loan loss deduction occurs for tax purposes, which will always increase the book income adjustment by the full amount of the deduction. In other words, tax and book deductions are not fully offsetting, as it was contemplated they would be.

**Proposed Technical Correction**

It is proposed that there be an adjustment to AMTI solely for purposes of determining the book income adjustment in 1988 and 1989. Any tax deduction taken by a taxpayer that represents the charge-off of a loan against an addition to the taxpayer's loan loss reserve in a prior post-1986 taxable year would be added to AMTI (the "loan loss addback"). This adjustment could not exceed the "negative book income preference" -- i.e. the amount by which adjusted net book income was less than AMTI in 1987.

An additional adjustment may be necessary if any additions to bad debt reserves are reversed by a bank in a subsequent year. Adjusted net book income for the 1988 and 1989 taxable years should be decreased to reflect any recapture of amounts that were added to the taxpayer's bad debt reserve in prior post-1987 taxable years. The amount of this decrease should also be limited to the negative book income adjustment.

**Reasons for Amendment**

The purpose of the corporate AMT adopted in the 1986 Act is to ensure payment of at least a 20 percent tax on economic income. A perception of unfairness in the tax system arises, it is believed, when some taxpayers with economic income pay little or no tax, even though the reduced tax liability is a result of incentives and preferences built into the tax system and despite the fact that the benefits of tax preferences are very often passed through by the taxpayers who are their direct beneficiaries.

The book income adjustment to taxable income created by the 1986 Act is not a preference item in the general sense. It is addressed to no particular tax preference item, but only to general differences in income reporting, which may arise for many reasons. No explanation of the purpose of the book income adjustment is provided in the legislative history of the 1986 Act. The Joint Committee staff's General Explanation indicates only that its purpose was to "achieve both real and apparent fairness" by requiring that some tax be paid whenever a taxpayer publicly reports earnings on its financial statements. General Explanation at 434.

The purpose of the minimum tax credit is to ensure that, if a deferral preference creates a timing difference, the same amount of income will not be taxed twice -- once when a deduction is taken for regular tax purposes and again after the timing difference reverses. However, in the case of the reverse timing difference created by the repeal of the bad debt reserve, the minimum tax credit provides no relief. The absence of relief is particularly unfair because this timing difference is not a preference. There is no deferral of the tax liability (as ordinarily results from a timing preference); instead there is an acceleration of tax liability. Under the minimum tax as presently in effect, taxpayers with identical income may incur different tax liabilities, as the examples set out in the Appendix demonstrate. Such a result is inherently unfair and should certainly be remedied.

The proposed loan loss addback adjustment is intended to avoid the double taxation that otherwise would result from this reverse timing difference. Under the proposed provision, taxpayers with similar economic incomes for the period during which the book income adjustment is in effect will pay similar amounts of tax. The provision should create no perception of unfairness. Indeed, it is essential to prevent real unfairness. As the attached example illustrates, a taxpayer that has no economic income could have a minimum tax liability absent the type of adjustment being proposed. Clearly it is fair to prevent the assessment of a double tax and provide equitable tax treatment for similarly situated taxpayers.

The double tax that can result from the timing difference created by the repeal of the tax bad debt reserve is obviously an unintended glitch. The drafters of the minimum tax provision explicitly assumed that, absent tax preferences, AMTI would not be less than book income. Senate Report at 520 n. 4. In fact, that is exactly what happens to a commercial bank that maintains a book bad debt reserve when it writes off a loan for tax purposes. The bad debt deduction in the later year corresponds to a book deduction claimed in an earlier year (which is not a tax preference but a tax penalty). Moreover, the double taxation problem created by the repeal of the bad debt reserve is limited to the 1987 through 1989 taxable years. The adjusted current earnings mechanism that becomes effective in 1990 will eliminate the loan loss reserve problem because it is limited to recapturing true tax preferences and thus does not affect bad debt deductions. And the adjusted current earnings concept was intended to be at least as broad as the book income adjustment in its coverage. General Explanation at 435.

In addition, if no technical correction is made, commercial banks might be discouraged from making needed adjustments to loan loss reserves because of the double tax liability that might result. This result conflicts with the expressed intent of Congress that the minimum tax provision not interfere with appropriate methods of accounting. General Explanation at 456.

This statement is submitted by John E. Chapoton, Thomas A. Stout, Jr., Christine L. Vaughn and Debra J. Duncan of Vinson & Elkins, 1455 Pennsylvania Avenue, N.W., Washington, D.C. 20004-1007, telephone no. (202) 639-6500, on behalf of the following:

Bank of America
Bankers Trust Company
Chemical Bank
Citibank
Continental Illinois National Bank and Trust
    Company of Chicago
First National Bank of Chicago
Irving Trust Company
Manufacturers Hanover Trust Company
Mellon Bank

## APPENDIX

The following example illustrates the inequity that occurs when two banks, which over time have the same book income and charge-offs, use different financial accounting methods. The example demonstrates that the present AMT does not contemplate the existence of the reverse timing difference created by loan loss reserves. The result is that one bank pays tax while the other pays no tax even though neither bank has any economic income. Contrary to Congressional intent that the book income adjustment not interfere with financial accounting methods, total tax paid depends on whether the taxpayer uses a reserve method of accounting for book purposes.

Assumptions:

- Bank A and Bank B have no alternative minimum tax preferences or adjustments other than the book income adjustment. Thus, taxable income and alternative minimum taxable income before the book income adjustments are equal.
- Bank A has a loan loss provision for book purposes in 1987, and takes bad debt deductions for tax purposes equal to that provision over 1988 and 1989. Bank B has a book loan loss provision for each year equal to its tax charge-off for that year.
- Neither Bank A nor Bank B have a portfolio of pre-8/7/86 tax-exempt obligations, or any other tax-exempt obligation which would be subject to the minimum tax through the book/tax adjustment.
- Neither Bank A nor Bank B have foreign tax credits in any year.

### BANK A

| | FINANCIAL STATEMENT | | | TAX RETURN | | |
|---|---|---|---|---|---|---|
| 1987: | Book Income Before Loan Loss | = | $ 1,000 | Taxable Income | = | $ 1,000 |
| | Loan Loss Provision | = | 3,500 | Charge-Off | = | 0 |
| | Pre-Tax Book Income (Loss) | = | $ (2,500) | Net Taxable Income | = | $ 1,000 |

Summary:

| | Book | Tax Return |
|---|---|---|
| Income | $ (2,500) | $ 1,000 |
| Loan Loss/Charge-Off | 3,500 | 0 |
| Minimum Tax Liability | 0 | N/A |
| Regular Tax Liability | N/A | 400 |

| | | | | | | |
|---|---|---|---|---|---|---|
| 1988: | Book Income Before Loan Loss | = | $ 1,000 | Taxable Income | = | $ 1,000 |
| | Loan Loss Provision | = | 0 | Charge-Off | = | 1,000 |
| | Pre-Tax Book Income | = | $ 1,000 | Net Taxable Income | = | $ 0 |

Summary:

| | Book | Tax Return |
|---|---|---|
| Income | $ 1,000 | $ 0 |
| Loan Loss/Charge-Off | 0 | 1,000 |
| Minimum Tax Liability | 100 | N/A |
| Regular Tax Liability | N/A | 0 |

| | | | | | | |
|---|---|---|---|---|---|---|
| 1989: | Book Income Before Loan Loss | = | $ 1,500 | Taxable Income | = | $ 1,500 |
| | Loan Loss Provision | = | 0 | Charge-Off | = | 2,500 |
| | Pre-Tax Book Income | = | $ 1,500 | Net Taxable Income | = | $ (1,000) |

Summary:

| | Book | Tax Return |
|---|---|---|
| Income | $ 1,500 | $ (1,000) |
| Loan Loss/Charge-Off | 0 | 2,500 |
| Minimum Tax Liability | 50 | N/A |
| Regular Tax Liability | N/A | 0 |
| Regular Tax Refund | N/A | 400 |

Cumulative Summary:

| | Book | Tax Return |
|---|---|---|
| Income | $ 0 | $ 0 |
| Loan Loss/Charge-Off | 3,500 | 3,500 |
| Minimum Tax Liability | 150 | N/A |
| Regular Tax Liability | N/A | 400 |
| Regular Tax Refund | N/A | 400 |

BANK B

| | FINANCIAL STATEMENT | | | TAX RETURN | | |
|---|---|---|---|---|---|---|
| 1987: | Book Income Before Loan Loss | = | $ 1,000 | Taxable Income | = | $ 1,000 |
| | Loan Loss Provision | = | 1,000 | Charge-Off | = | 1,000 |
| | Pre-Tax Book Income (Loss) | = | $ 0 | Net Taxable Income | = | $ 0 |

Summary:

| | Book | Tax Return |
|---|---|---|
| Income | $ 0 | $ 0 |
| Loan Loss/Charge-Off | 1,000 | 1,000 |
| Minimum Tax Liability | 0 | N/A |
| Regular Tax Liability | N/A | 0 |

| | | | | | | |
|---|---|---|---|---|---|---|
| 1988: | Book Income Before Loan Loss | = | $ 1,000 | Taxable Income | = | $ 1,000 |
| | Loan Loss Provision | = | 1,000 | Charge-Off | = | 1,000 |
| | Pre-Tax Book Income | = | $ 0 | Net Taxable Income | = | $ 0 |

Summary:

| | Book | Tax Return |
|---|---|---|
| Income | $ 0 | $ 0 |
| Loan Loss/Charge-Off | 1,000 | 1,000 |
| Minimum Tax Liability | 0 | N/A |
| Regular Tax Liability | N/A | 0 |

| | | | | | | |
|---|---|---|---|---|---|---|
| 1989: | Book Income Before Loan Loss | = | $ 1,500 | Taxable Income | = | $ 1,500 |
| | Loan Loss Provision | = | 1,500 | Charge-Off | = | 1,500 |
| | Pre-Tax Book Income | = | $ 0 | Net Taxable Income | = | $ 0 |

Summary:

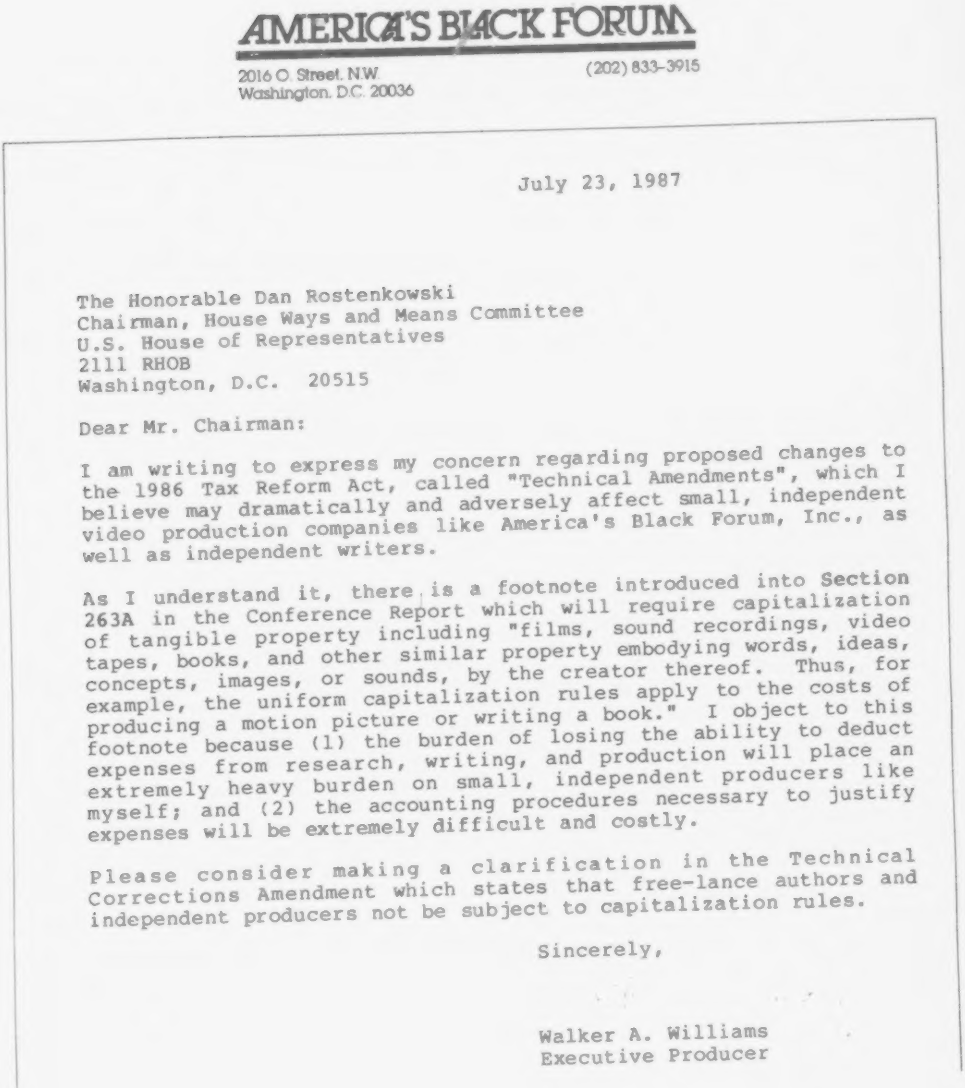
| | Book | Tax Return |
|---|---|---|
| Income | $ 0 | $ 0 |
| Loan Loss/Charge-Off | 1,500 | 1,500 |
| Minimum Tax Liability | 0 | N/A |
| Regular Tax Liability | N/A | 0 |

Cumulative Summary:

| | Book | Tax Return |
|---|---|---|
| Income | $ 0 | $ 0 |
| Loan Loss/Charge-Off | 3,500 | 3,500 |
| Minimum Tax Liability | 0 | N/A |
| Regular Tax Liability | N/A | 0 |

Note: This example also illustrates what the result would be if adjusted earnings and profits were the measure for the minimum tax adjustment, rather than the book/tax adjustment.

## Title VIII
## Section 803 (Industry comments)



AMERICA'S BLACK FORUM
2016 O. Street, N.W.
Washington, D.C. 20036
(202) 833-3915

July 23, 1987

The Honorable Dan Rostenkowski
Chairman, House Ways and Means Committee
U.S. House of Representatives
2111 RHOB
Washington, D.C.  20515

Dear Mr. Chairman:

I am writing to express my concern regarding proposed changes to the 1986 Tax Reform Act, called "Technical Amendments", which I believe may dramatically and adversely affect small, independent video production companies like America's Black Forum, Inc., as well as independent writers.

As I understand it, there is a footnote introduced into Section 263A in the Conference Report which will require capitalization of tangible property including "films, sound recordings, video tapes, books, and other similar property embodying words, ideas, concepts, images, or sounds, by the creator thereof. Thus, for example, the uniform capitalization rules apply to the costs of producing a motion picture or writing a book." I object to this footnote because (1) the burden of losing the ability to deduct expenses from research, writing, and production will place an extremely heavy burden on small, independent producers like myself; and (2) the accounting procedures necessary to justify expenses will be extremely difficult and costly.

Please consider making a clarification in the Technical Corrections Amendment which states that free-lance authors and independent producers not be subject to capitalization rules.

Sincerely,

Walker A. Williams
Executive Producer

# STATEMENT OF THE

# AMERICAN PETROLEUM INSTITUTE

The American Petroleum Institute is a trade association representing all segments of the petroleum industry. In anticipation of technical corrections to the 1986 Tax Reform Act, API recommended that section 263A of the Code, added by section 803 of the 1986 TRA, be amended to exclude foreign intangible drilling costs (IDCs) described in section 263(i) of the Code and amounts described in section 291(b) of the Code from the uniform capitalization rules. IDCs described in section 263(c) are excepted from the capitalization rules by section 263A(c)(3).

Section 108(b) of the Technical Corrections Act adds section 291(b) to the list of costs excepted under section 263A(c), but fails to address section 263(i) foreign IDCs. Apparently, the omission of 263(i) was inadvertant. It is recommended that 263A(c)(3) be amended to specifically except IDCs described in section 263(i).

Statement by

NICHOLAS A. VELIOTES
Association of American Publishers, Inc.
Washington, D.C.

WRITTEN COMMENTS ON H.R. 2636
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES

---

My name is Nicholas A. Veliotes, and I am President of the Association of American Publishers ("AAP"), whose members include the bulk of book publishers in the United States. The Association is represented in this matter by Mortimer Caplin of the Washington law firm of Caplin & Drysdale.

Let me first summarize the views of the AAP on an issue of vital importance to the book publishing industry of this country:

1. New section 263A contains an ambiguity that the Treasury interprets as denying book publishers a section 174 deduction for its prepublication "research or experimental" expenses ("R&D") in developing instructional, reference and professional materials. The TCA should amend section 174 to make it clear that book publishers, like other American businesses, are eligible to deduct these R&D costs.

2. The activity of book publishers in creating new instructional, reference, and professional works, involves efforts that, by their nature, clearly constitute R&D and that, for any other industry, would qualify for deduction under section 174. However, Treasury Regulations § 1.174-2(a)(1)--for some vague and unexplained reason--generally denies section 174 deductions for expenditures for "research in connection with literary, historical, or similar projects." And the Internal Revenue Service, in Revenue Ruling 73-395 (1973-2 C.B. 87), specifically rejected the book publishers' plea for equal treatment when it pronounced that "costs incurred in the writing, editing, design and art work directly attributable to the development of the textbooks and visual aids do not constitute research and experimental expenditures under Section 174."

3. In 1976 Congress enacted legislation (section 2119 of the 1976 Tax Reform Act) that blocked the IRS' efforts to deny these deductions. The effect of the 1976 legislation has been to allow book publishers to deduct, as current expenses, their editorial and similar costs incurred in the process of developing new books, thereby maintaining equality with other industries.

4. Based on a footnote in the 1986 Conference Report, the Treasury now takes the position that the 1986 Act, by implication, repealed the 1976 protective statute (section 2119). It further insists that costs of developing printed materials are automatically excluded from section 174 treatment, regardless of the character of the materials or the development process involved.

5. Treasury's interpretation of section 263A singles out and discriminates against the book publishing industry. For virtually all other industries, costs of developing new products can still be deducted currently as R&D costs under section 174. Book publishers, practically alone, would be denied these current deductions.

6. AAP submits that the Treasury's position (embodied in its temporary and proposed regulations under section 263A) is inconsistent with the terms of both the 1986 Act and the 1976

legislation, as well as grossly unfair and contrary to sensible national policies and priorities.

7. AAP requests that the Technical Corrections Act include a provision clarifying that book publishers' R&D costs for instructional, reference, and professional materials are eligible for treatment as R&D costs under section 174. The clarification would apply only to these limited classes of publications. Further, it would be confined only to costs that clearly constitute R&D. Other costs--such as author's advances and production costs (including paper, printing, and binding, as well as costs of preparing plates from which the materials are printed)--would be subject to capitalization.

## R&D EXPENDITURES BY PUBLISHERS

The activities of a book publisher in preparing instructional, reference, or professional materials involve work that qualifies as "research or experimental" ("R&D") by any reasonable standard. We have submitted, for the information of the Committee, a detailed description of how a book publisher develops an elementary textbook system. Publishers of materials for use at other educational levels, as standard reference works, or for home-study or professional development follow similar procedures.

In general, the process begins with careful research into the need for a new or improved product, followed by preliminary testing and definition of pedagogical and substantive approaches and concepts. This phase features extensive review of the latest pedagogical data and analysis, as well as interacting with teachers, academics and school administrators. Thereafter, the publisher's staff, in collaboration with the author or team of authors selected to carry out the project, defines the general specifications for the product. Based on these specifications, the publisher and author team work together to create one or more prototypes of the new product.

These prototypes are then tested and evaluated by the publisher's staff, working in classroom settings with teachers and students and with experts in the field, to develop highly detailed specifications. These specifications function as blueprints for the authorship team in preparing the first full manuscript. The authors then prepare successive drafts, which are reviewed by the publisher's staff for conformity to the specifications, and subjected to further field testing and evaluations.

Throughout the process, the publisher is continually and closely involved in classroom testing and in expert evaluation to determine if the product will function properly in the intended educational setting. Based on this trial-and-error approach, the product is modified until a final version is ready to be prepared for printing and mass production. In some cases, particularly in the case of elementary and secondary school textbooks subject to a governmentally operated "adoption" procedure, the process of testing and modification continues even after the materials are initially prepared for printing and manufacture.

The process of developing instructional, reference, and professional material is characterized by heavy involvement of the publisher's staff, not merely in revising an author-submitted manuscript, but in conceptualizing the product, developing detailed plans, and working with potential users and substantive and instructional experts in testing and evaluating preliminary outlines and drafts. In response to these tests and evaluations, the product under development is continually modified and adjusted as the development process goes on.

In all instances, this preproduction development process for instructional, reference, and professional materials is not what is normally thought of as "editing." It is a radically more complex, sophisticated and intense process. It considers not only the order and organization of the words used, but the whole format for presenting the material, including the scope of the subject covered, the order of presenting subjects, the relation of graphics and illustrations to the educational objectives of the publication, and the effectiveness of particular methods of presenting the material. It embodies classroom field tests and expert evaluations of preliminary designs and prototypes that feed back into the process.

In many cases, the product resulting from these R&D efforts comprises several interrelated elements to be used in conjunction with each other. For example, in the case of elementary school instructional materials, the product developed by this process of research, experimentation and testing, with modifications based on results at earlier stages, is not a single textbook, but a whole system of teaching aids (such as filmstrips, overhead transparencies, demonstration materials, and computer software), teacher manuals and special teacher editions of the text, student workbooks, and testing materials.

The instructional publisher's systematic planning, testing, and evaluation throughout a product development process, feeding back into continual modifications of the emerging product to insure effective application of knowledge and techniques to a final product, is exactly analogous to the R&D process of other industries which apply technology and the results of experimentation to the development of new products.

There is no sound reason to deny publishers of instructional, reference, and professional materials the same tax treatment for R&D costs that manufacturers of other products enjoy. Indeed, the critical social importance of quality educational materials makes it especially appropriate to allow current deduction treatment in these cases.

## LEGISLATIVE AND REGULATORY BACKGROUND

Since 1954--and, in practice, before that--costs of research and development of new products have generally been allowed as a current deduction under section 174, even if those costs would otherwise have to be capitalized. In 1986, Congress adhered to the consistent practice of favoring new product development by creating a major statutory exception to the new uniform capitalization rule--section 263A(c)(2), which specifically preserves the section 174 deduction for "research or experimental" expenditures ("R&D"). Consequently, most industries will gain significant relief by being able to continue to deduct costs of product R&D.

Barred from this relief, however, is the book publishing industry, which has been disqualified from using section 174 by the Treasury's erroneous reading of section 263A. As a result, book publishers will be subject to the full rigor of section 263A, even for R&D devoted to the creation of "intangible" assets in the form of copyrights--despite the fact that section 263A specifically applies to real property and only "tangible" personal property.

### Treasury Regulations § 1.174-2(a)(1)

Section 174 was included in the 1954 Act as originally enacted to--in the words of the reports in both Houses of Congress--"encourage taxpayers to carry on research and experimentation." H.R. Rep. No. 1337, 83d Cong. 2d Sess. 28 (1954); S. Rep. No. 1622, 83d Cong. 2d Sess. 33 (1954). Section 174 does not discriminate among different kinds of products, and there was no discussion of any such limitation when it was enacted.

At the outset, the regulations under section 174 interpret its scope very broadly to include "all ... costs incident to the development of ... a product." Treas. Reg. § 1.174-2(a)(1). In practice, the cases, published revenue rulings, and internal IRS pronouncements reflect this broad view and permit almost all industries to elect under section 174 to deduct their product development costs. In many cases, neither the products nor the process have the high degree of technical content manifested in the development of instructional, reference, and professional publications.

Treasury has, however, resisted application of section 174 deductions to any printed product, regardless of its character. Reg. § 1.174-2(a)(1) (originally adopted in 1957) has provided that "research or experimental expenditures" do not include "expenditures paid or incurred for research in connection with literary, historical, or similar projects." Although this could reasonably be read only as preventing amateur writers from attempting to deduct the costs of their "research hobbies," Treasury has read it as barring R&D treatment for any product embodied in print, even highly technical material or material developed on the basis of a process of analysis and experimentation that would clearly qualify as R&D in any other context.

The discrimination against book publishers is put into sharp focus when one recalls that in 1983 Treasury spokesmen recognized that R&D deductions are claimed by taxpayers in such varying business lines as fast food restaurants, baked goods, home building, banking, stock brokerage and the like. Even more startling, computer software products--commonly produced by book publishers, and marketed and inventoried side-by-side with books containing identical information--are given generous R&D deduction treatment by the IRS. It is anomalous to permit R&D deductions for one type of intellectual product while denying it to another similar product.[1]

## Revenue Ruling 73-395 and Congressional Criticism

Prior to 1973, most book publishers followed their consistent practice (for book and tax purposes) of deducting preproduction editorial and similar costs without disruption by the IRS. In 1973, however, the Internal Revenue Service issued Rev. Rul. 73-395, 1973-2 C.B. 87, expressing the IRS position that preproduction editorial costs must be capitalized as part of the cost of the book copyright and are not deductible under section 174 on the ground that "costs incurred in the writing, editing, design and art work directly attributable to the development of the textbooks and visual aids do not constitute research and experimental expenditures under section 174."

This proposed treatment for the book publishing industry was strongly criticized as discriminatory and unjustified, and corrective legislation was introduced on a number of occasions. In 1974, for example, Congressman Dan Rostenkowski co-sponsored legislation to this end and, in doing so, referred back to the 1954 enactment of section 174, stating:

> "There is no suggestion in these reports that section 174 would not apply to the costs of research and experimentation necessary to develop products of book publishers, such as

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[1] In practice, more and more instructional, reference, and professional materials are appearing in both computer and print form, leading to the anomalous situation in which the costs of creating and developing a printed mathematics workbook, for example, are not eligible for the deduction, but the cost of developing a program for presenting the same information on a computer screen would be eligible.

> textbooks, reference books, visual aids, and other teaching aids, merely because the taxpayer's business is publishing or because the teaching aid or other product of a publisher is in the form of a printed book rather than in the form of a mechanical device. Section 174 should not be interpreted to discriminate against book publishers in the business of developing or in improving reference books, teaching aids or other products."

Further criticizing IRS' interpretation of the Reg. § 1.174-2(a)(1) disqualification of "research in connection with literary, historical, or similar projects," Mr. Rostenkowski urged that "this regulatory exclusion should be confined to its proper scope, for example, to preclude the amateur novelist from deducting his essentially personal expenses in the guise of business research expenses."

## Section 2119 (Revenue Act of 1976)

In 1976, Congress responded to these criticisms of Treasury's position by enacting section 2119 of the Revenue Act of 1976 to block IRS' use of Revenue Ruling 73-395 and to allow publishers to continue to treat their editorial and other "prepublication expenditures" "in the manner ... applied consistently by the taxpayer to such expenditures before the date or issuance of such revenue ruling." Congress further cautioned IRS that any future regulations relating to this issue "shall apply only with respect to taxable years beginning after the date on which such regulations are issued."

No action has been taken by Treasury to date to comply with this Congressional direction. Consequently, the effect of the 1976 law was to maintain de facto parity between publishing and other industries.

This detailed and specific congressional directive concerning prepublication expenses of book publishers was never mentioned in the extensive legislative history of the uniform cost capitalization rules that became section 263A in the 1986 Act. No reference to section 2119 appears anywhere in the text or legislative history of the 1986 Tax Reform Act. No hearings were held on this issue, and no opportunity was given to the publishing industry to present its views.

## Temporary and Proposed Section 263A Regulations

However, Treasury's temporary and proposed section 263A regulations now take the position that section 2119 of the 1976 Act was in essence repealed by section 263A, and that all book publisher's product development costs must be capitalized under section 263A and cannot be deducted under section 174. This position is inconsistent both with the 1986 legislation and with basic principles of statutory construction.

Repeal by implication, says the classic maxim of statutory interpretation, is generally disfavored. Further, as a matter of substance, a very general later law should not be viewed as repealing a highly specific earlier one.

Even if section 263A did override the 1976 provision, capitalization of the publishers' costs at issue is not necessarily required. For section 263A states that the new rules apply only to real property and "tangible" personal property. In turn, the latter term is statutorily defined as including "a film, sound recording, video tape, book, or similar property." As to the book publishing industry, this would appear to mean the costs of the actual tangible product--platemaking, printing, as well as other production costs.

## 1986 Conference Report

The Conference Report repeats that "application of the uniform capitalization rules with respect to production activities is limited to tangible property." But in a last-minute footnote added to Conference Report (II-308), the term "tangible property" is broadly expanded to include a number of intangible items:

> " ... films, sound recordings, video tapes, books, and other similar property embodying words, ideas, concepts, images, or sounds, by the creator thereof. Thus, for example, the uniform capitalization rules apply to the costs of producing a motion picture or researching and writing a book."

Despite this murky 1986 legislative background, the proposed section 263A regulations elevate the Conference Report footnote to a statutory level. They declare that section 263A, as a new Code section, is not included within the coverage of section 2119 and that, in any case, section 263A repeals section 2119. They do so by denying section 174 treatment for, and flatly requiring capitalization of, "prepublication expenditures incurred by publishers of books and other similar property, including payments made to authors of literary works, as well as costs incurred by such publishers in the writing, editing, compiling, illustrating, designing and development of books or similar property."

This Treasury position may aptly be described as legislation by footnote.

In light of the strained regulatory position taken by the Treasury--over the strong objections of the industry and expressions of concern by many members of Congress--on the meaning of section 263A, the only feasible solution for book publishers is to seek corrective legislation, to clarify that section 174 provides them with equivalent product development deductions comparable to those given to other businesses.

## PROPOSED CORRECTION

The AAP urges that the appropriate resolution of this issue is to afford publishers of instructional, reference, and professional materials the same treatment for their R&D costs as is afforded other businesses. Such action would be fully consistent with the terms and purposes of the 1986 Act and would prevent the severe adverse impacts that would flow from Treasury's misreading of the 1986 Act as applied to publishers' R&D costs.

### Request for Parallel Tax Treatment

The book publishing industry is not asking for special treatment, but only for equal treatment with other industries.

Under the correction we propose, section 174 would explicitly be declared applicable to research and development expenditures of a publisher of "instructional materials." Qualification as "instructional materials" would be expressly limited to materials prepared for publication with the principal purpose of use in systematic instructional activities in elementary, secondary, or vocational schools, or in post-secondary schools; as reference works or technical materials for use by persons in the conduct of their professions; or as instructional reference works, i.e, materials published for self-instructional activities in the liberal arts, the sciences, or similar disciplines and standard reference works such as encyclopedias, dictionaries, and thesauruses. Publications not coming within these definitions of "instructional materials" would not be covered.

Further, even for the limited category of publications covered, only those prepublication costs that qualify as R&D costs would be eligible. As explained above, for the publishing industry, those qualifying costs are the costs of identifying the need for a new or improved product, of gathering laboratory data related to it, of conceptualizing the product, of developing and field testing prototypes, of developing the manuscript, of designing and field testing the final layouts, of making content and design changes as a result of such field testing, and of pilot testing and adoption procedures. Not within the purview of section 174, but instead subject to capitalization, would be the following: Advance royalty payments to authors and costs of actual manufacture of the books or other products, including platemaking costs (material, typesetting, film making and labor), as well as production costs (paper, ink, binding, jackets and labor).

In sum, this committee's adoption of the proposed amendment would:

-- Correct an improper interpretation of the 1986 Act,

-- Eliminate the unjustified discrimination produced by Treasury's interpretation,

-- Foster innovation and creativity by educational book publishers,

-- Support their efforts to improve and modernize teaching, reference, and professional materials, and

-- Serve the public interest by strengthening sensible national educational policies and priorities.

Association of American Publishers

Washington, D.C.
July 17, 1987

BH&S **Builders' Hardware & Supply Co.**
1516 15th Ave. West • P.O. Box C 79005
Seattle, WA 98119-3185 • Phone 281-3700

July 17, 1987

Honorable Dan Rostenkowski
Chairman, House Ways and Means
2111 Rayburn House Office Building
Washington, D.C. 20515

Re: Tax reform 1986
Purchasing - Inventory

Gentlemen:

"Inventory Expense Cost for IRS"

We are a wholesale business, we also maintain a Contract Department selling and servicing contractors and architects building residential and commercial buildings.

We employ close to 100 people, many of whom do work in many areas of our business - whether it be purchasing, warehousing, shipping, truck driving, picking up mail, running little errands, taking orders over the phone, taking inventory or filling orders etc.

To be frank the place is like an ant hill with no practical way of keeping track of their time on any one action on any one job.

We are also differenct than many other businesses in our so called catagory. We make it a point to stock many odds and ends which we stock for long periods. We compete with institutions like Ace and Cotter (you might call them mail order wholesalers) who pick the high turnover items from a product line and sell it direct at a low margin to the same retail outlet we sell to. Our livelyhood is to carry the odds and ends as well as to maintain a complete line and give service.

We maintain two (2) men who basically do nothing but purchase, some time is spent on taking inventory, they are supposed to assist in sales meetings and to acquaint the salesmen to new products. The writer of this letter is Chairman of the Board, who does oversee all problems. He also does purchasing and inventory checking a few minutes here and there, works on sales counter, even assists in order filling. Our Vice President and General Manager also does somewhat the same including purchasing of some lines, also checking and controlling the regular purchasing agents. Our Sales Manager also does some purchasing as well as doing an excellent job as Sales Manager directing and assisting 10 to 11 salesmen who call on the retail trade in most of the Pacific Northwest and Alaska. He also does regular sales calls to some customers.

We also have several other people doing purchasing and inventory control for speciality items relative to their departments along with their sales and service problems. It is very difficult to keep track of their time on inventory problems.

We have men working in order filling, packing, shipping (in our training department) who are also called upon to work any place where needed they are also involved in inventory taking as part of their training.

Our inventory turn may average 6%. Many items turn once a month or faster, again to maintain our inventory of "so called" hard to get items, some of our inventory only moves a couple of times a year.

Putting our inventory and control on computor is not practical (a long story) but we are attempting to, this may help solve some of these problems, no way entirely. To simply state it there is no practical way to put it down honestly in black and white just what our actual inventory control cost is.

Buyers, inventory counters, maintaining our checking and keeping our records up to date on stock cards by telephone clerks, filling clerks, whoever, 15 minutes etc., here and there.

Why not do like we used to do, a simple tax on our total profit. We would show more profit with less personnel and detail, both expensive.

Respectfully,

BUILDERS HARDWARE & SUPPLY CO.

Thomas M. Shannon
Chairman of the Board

P.S. Mrs Henry our president also does purchasing, expediting and many other duties

331 E. 44th Street
Apt 5F
New York, N.Y. 10017
August 16, 1987

The Honorable Dan Rostenkowski
Chairman
Committee on Ways and Means
1102 Longworth House Office Building
United States Congress
Washington, D.C. 20515

Dear Congressman Rostenkowski

Section 1706 of the 1986 Tax Reform Act has brought turmoil and despair into the ranks of the computer programmer consultants.

Its long term effect will be the paralysis of a profession which thrives on independent experimentation and innovation.

HR 792 is designed to correct the inequities contained in Section 1706. It needs your support for its passage.

As a computer consultant, I respectfully request that you look with favor on HR792, and give it its well merited legislative support.

Sincerely yours,
Dorothy Friedberg
Computer Projects, Inc

SOUTH-WESTERN PUBLISHING CO.

355 Conde Street, West Chicago, IL 60185
Telephone: 312 231-6000

August 4, 1987

The Honorable Don Rostenkowski, Chairman
House Ways and Means Committee
United States House of Representatives
Washington, DC 20515

Dear Representative Rostenkowski

It has been brought to my attention that the Association of American Publishers is seeking legislation to correct a Federal tax law problem that is very important to all book publishers.

Recently, the Treasure Department issued temporary and proposed regulations under section 263A of the Internal Revenue Code that would require book publishers to capitalize all prepublication expenditures including the type of developmental, research, and testing expenditures that other taxpayers are permitted to currently deduct as research and developmental costs. Until now, South-Western Publishing Company has deducted these prepublication expenditures under the Tax Reform Act of 1976 which was expressly allowed by Congress.

Of greatest concern is that the Treasury's interpretation of section 263A will hinder the innovation and creativity of educational book publishers who spend many years and considerable sums of money developing new and progressive instructional programs for our nations's schools. Our efforts to improve and modernize teaching and learning skills should not be handicapped by an apparent arbitrary bias against research and developmental activities of book publishers.

South-Western Publishing Company is asking for your active support of the legislation proposed by the Association of American Publishers which would allow book publishers to deduct research and developmental expenditures incurred with respect to educational books and related materials. This effort seeks a fair result that is important to preserving and improving the quality of education in our country.

Cordially yours

Edwin E Kadrmas

Edwin E. Kadrmas
Regional Vice-President

cf

cc: C. LeMoyne Smith

Cincinnati, OH 45227 • Carrollton, TX 75006 • Livermore, CA 94550 • West Chicago, IL 60185

**The Standard Oil Company**
200 Public Square—38-2605-K
Cleveland, Ohio 44114-2375
216 586-4614

**James V. Phillips**
Vice President, Tax

July 13, 1987

**STANDARD OIL**

Honorable Dan Rostenkowski
Chairman, Committee on Ways & Means
2111 Rayburn House Office Building
Washington, D.C. 20515

Re: Interest Capitalization Transition Rule

Dear Congressman Rostenkowski:

Congress recognized in implementing the depreciation and investment credit changes of the Tax Reform Act of 1986, that it would be inequitable to impose the new rules on corporations that had relied on pre-TRA law to plan and begin construction on major projects. Consequently, the Tax Reform Act provided transitional rules that exempted or "grandfathered" certain projects from the new rules.

One project that was grandfathered was the Kennecott copper mining modernization project in Salt Lake City, Utah. The project involves the complete modernization of the mine, transportation facilities and milling operations and has a total estimated cost of $350,000,000. The project will incorporate some of the largest state-of-the-art crushing, conveying, grinding and flotation equipment available in the industry today. When completed next year, the mine is expected to restore America's competitiveness in the world copper market. The project was specifically exempted from the application of the new depreciation rules under section 204(a)(5)(Q) of the Tax Reform Act.

In addition to the changes in the depreciation system and the Investment Tax Credit, the Tax Reform Act (section 803 (a)) also changed the rules on the capitalization of interest expense incurred during the construction period of a long term project like the one at Kennecott. Exercising the same rationale as that employed for the changes in the capital cost recovery area, Congress provided for transition rules to prevent undue economic hardship in the implementation of the new rules on interest capitalization.

Section 803(d) of the Act provided several transition rules and exemptions from the interest capitalization rules. Some are general in nature while others are project specific. Section 803(d)(3), for example, exempted all self-constructed projects provided substantial construction had occurred before March 1, 1986. Section 803(d)(4) exempted certain urban renovation

The Standard Oil Company is the
original Standard Oil founded in
Cleveland, Ohio, in 1870

projects but only one project (for an offshore oil platform), from the list of projects granted transition relief from the new depreciation rules.

The Kennecott project, although listed as exempt from the new cost recovery rules in the very same subsection as the offshore oil platform project, is not exempted from the interest capitalization rules. There is no material difference in circumstance, that we are aware of, that would warrant the drastically different tax treatment accorded these two projects.

It seems clear that Congress intended to alleviate the inequities associated with changing the tax consequences for a project that takes years to complete and that was conceived and begun long before the tax law change was contemplated. Congress established criteria for projects in order to qualify for transitional relief and the Kennecott project clearly met those criteria and qualified for such relief. We believe it was either a technical error or an oversight that this project was not given transitional relief from the interest capitalization rules and in order to accomplish the intent of Congress, we would urge that such relief be provided.

Consequently, we respectfully request that the transitional relief, granted in section 803(d)(4) of the Tax Reform Act of 1986, be extended to the Kennecott modernization project.

Sincerely,

J V. Phill

James V. Phillips
Vice President, Tax

## Section 803 (Authors)

**RONALD B. ADLER**
**415 Calle Granada**
**Santa Barbara, CA 93105**
**(805) 682-5680**

August 20, 1987

Congressman Dan Rostenkowski, Chairman
House Ways and Means Committee
1102 Longworth Building
Washington, D.C. 20505

Dear Congressman Rostenkowski:

I am writing to express my concern over Section 263(A) of the 1986 Tax Reform Act. This provision, described in the enclosed column from Newsweek magazine deserves to be stricken from the tax codes for two reasons:

- It unfairly discriminates against authors, who are now treated differently from other self-employed business people who are allowed to deduct their operating expenses as they occur.
- It threatens the productivity of the publishing industry, and hence the number of books, articles, plays, and movies that are likely to be written in the future.

I urge you to introduce legislation repealing Section 263 (A) of the Tax Reform Act, and will look forward to your response on this matter.

Sincerely,

MY TURN

# Only the Rich Will Write

The new tax law punishes the people who produce one of our nation's greatest resources

BY KITTY KELLEY

The self-employed writers of America, all 14,000 of us full timers and 47,000 part timers, face a financial guillotine. It could kill off many of our books, articles, plays and movies. We are the victims of a footnote in the 1986 Tax Reform Act, which states that we must capitalize our expenses.

This footnote, Section 263A (b), requires us to spread our expenses over the entire income-producing life of a book or other work. This means we can claim only a portion of our expenses in any one year—and none at all during the period we spend researching and writing, the time when we actually lay the money out. The new law further says that expenses may be applied only against income produced by the work in question and not against earnings from any other writing projects. This means that I must spend long, costly hours with my accountant trying to figure out how to apportion expenses among the books I write.

- Will "His Way: The Unauthorized Biography of Frank Sinatra" support my office rent? And for how long?
- Will the $4.12 I now receive in annual royalties from "Jackie Oh!," my 1978 book about Jacqueline Kennedy Onassis, cover paper clips for six weeks?
- Will the dwindling dollars from "Elizabeth Taylor: The Last Star" buy typing paper for another month?
- Does Liz, Jackie or Frank pay for photocopying? Which one picks up my phone bill? Health insurance? Postage?

Had this law been in effect when I was working on my first book, "The Glamour Spas," I would have gone broke in midstream because my research expenses in visiting America's fat farms far exceeded the publisher's advance. The book took two years to write and produced no income. And while I might have thought it worthy enough to be placed alongside "The American Way of Death," consumers in 1975 thought otherwise. Nevertheless, the new law requires writers to estimate the income-producing life of a book . . . and that is like asking us to calculate the number of stars that shine over Spokane.

It is virtually impossible for anyone (except perhaps for Shirley MacLaine, who seems to have an extraterrestrial sense about such things) to compute with accuracy how long a book will produce income. Can a farmer say how long his cow will give milk? Can a plumber gauge the life of his wrench? Probably with better accuracy than a writer trying to estimate the life of a book.

NEWSWEEK : AUGUST 24, 1987

With 50,000 books published in the United States every year, most writers would kill for one good income-producing year in hard-cover and another in paperback. However, the odds are against us because the shelf life of a book is about six weeks. If it doesn't sell in that time, it's returned to the publisher, dead on arrival. Resigned to the inevitability of the remainder tables, most writers only dream about publishers' backlists where books like "Goldilocks" and the Holy Bible are restocked and sold regularly.

**Artistic destruction:** Some among us get lucky and sell movie rights or see our books become mini-series on TV. About as many win lotteries, too. With the exception of superstars like Irving Wallace and James Michener and Judith Krantz, most writers must be content with a modest advance against royalties ($8,000 to $10,000), a small first printing (4,000 copies) and meager sales. And now because of the 1986 Tax Reform Act, writers—with an estimated median annual income of $7,900—will have to further penalize themselves for their creativity. People like David Halberstam ("The Reckoning: The Challenge to America's Greatness") and Edmund Morris ("The Rise of Theodore Roosevelt") and Robert A. Caro ("The Years of Lyndon Johnson: The Path to Power") will find it harder to enrich our understanding of American life. Their books require years of expensive research.

Under the current law, William Faulkner, whose works never earned much money while he was alive, might not have been able to produce "The Sound and the Fury." Eugene O'Neill might have been discouraged from writing "Desire Under the Elms." Could Joseph Heller have spent nearly eight years writing "Catch-22"?

As a writer, I pay a self-employment tax, but unlike other self-employed professionals such as doctors, lawyers and accountants, I am now barred from deducting ordinary and necessary business expenses. My friend Larry L. King, the funny man who wrote "The Best Little Whorehouse in Texas," has spent the last four years working on his second play, "The Night Hank Williams Died." He has invested thousands of dollars in this project, traveling around the country to meet with agents, producers and directors, trying to stage productions, hire talent, arrange music. The play has yet to produce any income and so, according to the new law, the playwright will have to swallow all of his expenses.

Even Ivan Boesky was allowed to deduct his losses in the stock market.

Surely Congress in its wisdom did not intend to punish the people who produce one of our nation's greatest resources. Did those senators and representatives who allocate hundreds of millions of dollars for Star Wars mean to plunder the libraries and bookstores of the United States? I can't believe that our lawmakers, many of them authors themselves, intended such artistic destruction.

Without prompt congressional action, few American authors will be able to continue earning a living writing books. And the Faulkners of today, the budding O'Neills in the early stages of their careers won't be able to nurture their talents. Our lawmakers may not have recognized the import of that small footnote buried in 878 pages of tax legislation, but unless they do something now, those few phrases can render meaningless much of what the U.S. Constitution does to shield writers with copyright protection and First Amendment guarantees.

If you can't afford to write, all the protections in the world won't make a difference.

*The author of celebrity biographies, Kelley lives in Washington, D.C.*

22 August 1987

The Honorable Dan Rostenkowski
United States House of Representatives
Washington, D.C. 20515

Dear Mr. Rostenkowski:

As Chairman of the Ways and Means Committee and a representative of my home state, you are one of the persons to whom I feel I can appeal.

I am a published author of children's books, i.e. THE WONDERFUL SHRINKING SHIRT, THE GOOD-BY DAY, IT'S O.K. TO CRY and others. Writers -- and particularly writers of children's books -- know very little return on the hours spent on producing their work. I'm deep into research on an 8-to-12-age novel based on the Blackhawk War, set in this northwest Illinois area. But for all the time and money I've put into pursuing this information, depending on the preferences of editors and the changing demands of the marketplace, I may have no return at all. Very few writers earn their living from their writing, but must augment their income with other jobs.

The capitalization rules in the 1986 Tax Reform Act applied to freelance authors' expenses in researching and writing a book would prove a hardship not only unfair but unbearable.

I urge that a clarification to that Act be made in the Technical Corrections Amendment Bill, stating that freelance author's expenses in researching and writing a book not be subject to capitalization rules.

Thank you for your time and concern.

Sincerely,

Leone Castell Anderson

Leone Castell Anderson

13115 E. Chelsea Rd.
Stockton, IL 61085

## MEMORANDUM REGARDING THE NEED FOR A TECHNICAL CORRECTION TO SECTION 263A TO EXCLUDE PROFESSIONAL WRITERS' RESEARCH AND WRITING EXPENSES FROM THE UNIFORM CAPITALIZATION RULES

This memorandum is submitted by The Authors Guild, Inc. regarding the need for a technical correction to the Tax Reform Act of 1986 (the "Act") to exclude from the uniform capitalization rules the research and writing expenses of professional authors. Such an amendment is necessary because of the undue burden that application of these complex and uncertain rules will impose on professional writers -- a burden that, it is submitted, is wholly disproportionate to any governmental interest in the application of the capitalization requirements in this setting. Stated simply, the rules of Section 263A as they apply to authors' expenses are virtually unworkable; and their application to a group of individuals who in general derive only modest income from writing is completely at variance with sound tax policy. The amendment is further justified to prevent the discriminatory application of Section 263A to only a single group of persons that derives income from services.

### Background

The uniform capitalization rules contained in Section 263A of the Internal Revenue Code of 1986 were enacted because:

> "The Congress believed that, in order to more accurately reflect income and make the income tax system more neutral, a single, comprehensive set of rules should govern the capitalization of costs of producing, acquiring, and holding property, including interest expense, subject to appropriate exceptions where application of the rules might be unduly burdensome."[1]

In general, the capitalization of such costs is in furtherance of the basic tax accounting objective of matching income and related expense items.

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[1] Joint Comm. on Taxation, General Explanation of the Tax Reform Act of 1986 508-09 (1987).

Prior to adoption of the Act, the ordinary and necessary business expenses of professional authors were deductible when paid under Section 162.[2] Although the Internal Revenue Service contended that former Section 280 (enacted in 1976 to require capitalization of expenses relating to production of films, books, records, etc.) barred the deduction of authors' research and writing expenses, that assertion was rejected by the Court of Appeals for the Second Circuit, which held that the intended reach of that section was tax shelter operations and book publishers, rather than authors.[3]

The possibility that the Act's uniform capitalization rules might apply to the research and writing expenses of authors first emerged in the Conference Explanation of the Act. The treatment of authors' expenses is not addressed in new Section 263A itself, or in the House or Senate bills or accompanying reports. Moreover, it is entirely plausible to read new Section 263A, like former Section 280, to be altogether inapplicable to authors' research and writing expenses.[4]

Nonetheless, the following sentences appeared in a footnote in the Conference Explanation of the Act:

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[2] No assertion is made that expenses associated with writing activity that fails to satisfy the "hobby loss" provisions of Section 183 are, or should be, deductible under Section 162.

[3] See Hadley v. Commissioner, 819 F.2d 359 (2d Cir. 1987), rev'g 86 T.C. 764 (1986) and 51 T.C.M. 948 (1986). Former Section 280 required capitalization of amounts attributable to the "production of a . . . book . . . ." Section 280(a), as in effect prior to the Tax Reform Act of 1986.

[4] In relevant part, Section 263A applies to the "production" of "tangible personal property." Section 263A(b)(1). The term "produce" is defined for this purpose to include "construct, build, install, manufacture, develop, or improve." Section 263A(g)(1). Only through a strained reading of these words could the act of writing a manuscript be included among the targeted activities. Moreover, while the statute defines "tangible personal property" to include a "book" (Section 263A(b) flush language), the logical effect of that provision would seem to be to subject the manufacturer of the book (i.e., the publisher) to the new rules, rather than the author of the manuscript that underlies the book to be published. The similarity of the structure of Section 263A and former Section 280 underscores the argument that neither section is applicable to authors.

> "For this purpose, tangible property includes films, sound recordings, video tapes, books, and other similarly [sic] property embodying words, ideas, concepts, images, or sounds, by the creator thereof. Thus, for example, the uniform capitalization rules apply to the costs of producing a motion picture or researching and writing a book.[5]

The Authors Guild, Inc. respectfully submits that the purported reversal of prior law by means of the footnote just quoted does not represent sound tax policy, and should expressly be rejected through an amendment in the Technical Corrections bill.

## Operation of Section 263A as It Applies to Authors

The burden that will be imposed on authors by application of the uniform capitalization rules can without exaggeration be characterized as extraordinary.

The general requirement of Section 263A in the present context is that all expenses allocable to writing activities that otherwise would be deductible under Section 162 must instead be capitalized to the account of the project in question. Such expenses then are recoverable as income is derived from the project, based on total revenues expected to be derived from the project.

The first step in the application of this rule requires fragmentation of all writing-related expenses across the writer's affected projects.[6] In a typical situation, a writer may be involved in writing a book, writing one or more articles, and perhaps working on certain related endeavors, such as preparing a speech. How might the author allocate the expenses that, not uncommonly, might be attributable in part to each of these projects? Although Treasury Regulations have been issued under Section 263A, no answer to this question is suggested. General tax principles would call for an allocation based on the relative fair market values of the projects, which presumably would be derived by discounting to present value the cash flows projected for each of the writing projects -- obviously a highly uncertain exercise as an author embarks upon the preparation of a manuscript.

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[5] H. Rep. No. 99-841, 99th Cong., 2d Sess. II-308 n.1 (1986) (emphasis added).

[6] Such expense might include telephone, freelance typist, utilities, cost of periodicals and the like.

In an effort to simplify the resolution of this cost allocation issue, it has been suggested by government staff that the author keep records of the time spent on each project, and allocate expenses -- presumably other than those specifically allocable to a given project -- on the basis of relative time spent. One might wonder whether the tax law should demand that the Nation's writers log their time spent on each poem, short story and essay in order to meet the requirements of Section 263A. In all events, however, keeping such time logs still will fail to produce the needed data where time is spent in a manner (e.g., research) that might benefit multiple projects.

Following on the exercise of allocating the writer's expenses to each of the projects in process, the question then to be addressed is the manner in which the capitalized costs may be recovered. We understand the applicable principles to be the following:[7]

(i) In general, the "income forecast" method must be used to determine the deductible portion of capitalized expenses by reference to the ratio of (x) annual revenues derived from the project to (y) total expected revenues for the project.

(ii) Annual re-assessments of the total expected revenues are required to be made.

(iii) In any years in which no income is earned from the project, no deduction may be claimed.

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[7] Rev. Rul. 60-358, 1960-2 C.B. 68.

(iv) Even if the project proves a failure, no deduction may be claimed unless the project is shown to have been abandoned.

Again, the theory that underlies the required analysis is not in question. The reality, however, is that any meaningful estimate of the projected royalties from a book or article will often be largely guesswork.[8] For example, what of the poem that is first printed in a magazine, later is collected in a volume of the author's poems, and still later is aggregated as part of the author's collected works? As another example, if poet A has had several poems anthologized, should poet B assume that his first poem published in the New Yorker also will one day appear in an anthology? Obviously, without information as to the expected pattern of publication, no meaningful estimate of future income can be derived. More fundamentally, even authors with a solid track record of publication at times find that later books do not sell well. The converse is also true. If it is not abundantly clear, these rules are unadministrable, and do not work.[9]

A final point regarding operation of the rules. Suppose a given project is a failure; when (if ever) may the taxpayer deduct the capitalized expenses? It has been suggested by government staff that the taxpayer must abandon his or her entire right in the project to qualify for a deduction. Presumably, that will require abandoning the author's copyright protection -- so that the work will become part of the public domain. Without debating the technical tax aspects of such a rule, from a public policy viewpoint such a requirement is most charitably characterized as unfortunate.

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[8] The Court of Appeals for the Second Circuit characterized the attempt to apply the income forecast method to authors' expenses in Hadley, supra, as follows:

> "In an activity as ephemeral as writing a book, the difficulties in estimating a future income stream and determining the time of ultimate write-off when it becomes clear that either a book will not be published or, if published, will not sell, appear immense."

[9] That is not to say that the income forecast method can never produce appropriate results. In the context of a movie company, or publishing house, the volume of amortizable films or books should yield reasonable results due to an averaging process. An individual author -- who may produce a major work only once in several years -- obviously has no such benefit of an averaging phenomenon.

## Compliance and Administration Issues

Each of the above fact-intensive issues will, of course, be subject to review by the Internal Revenue Service, with the ultimate resolution being time-consuming and expensive for both taxpayers and government. More fundamentally, this new system based largely on guesswork and surmise is certain to prove a source of taxpayer compliance difficulties. One would have thought that the government would strongly disfavor rules that will encourage aggressive position-taking based on the highly subjective matters such as those involved here.[10]

The merits of attempting, in any context, to provide a "matching" rule based upon such elusive matters as the required allocation of authors' costs, and the revenue estimated to be derived from projects, might fairly be debated. Whatever value the change might possess in the abstract, however, is completely swallowed up by the administrative and practical difficulties that will be faced by the group affected by this change. Virtually all of the affected taxpayers are individuals. It may be speculated that many prepare their tax returns without professional assistance. For these persons, it simply is the case that the tax law will be incomprehensible. These persons then will have the choice of incurring the expense of retaining a professional return preparer, or, in many cases, of failing to comply with the law. It is defensible to impose sophisticated tax accounting concepts to more accurately measure income on taxpayers who ordinarily employ such concepts in their business. It is totally indefensible to impose rules fraught with interpretive difficulty on persons who will frequently be without means to understand or deal with such rules.

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[10] One need only examine the numerous factual-issue cases that fill the Tax Court docket, or the various recent Code penalty provisions relating to valuation (e.g., the Section 6659 and 6660 valuation overstatement and understatement penalties) to confirm the difficult problem of tax administration that arises from the presence of factual issues in the tax law.

## Writers vs. Other Service Providers

Authors are not alone among service-providers in incurring expenses in advance of related receipts.[11] A lawyer may work for years on a case, particularly where a contingent fee is involved, and be permitted to deduct expenses when paid, far in advance of receipt of any fee income. Similarly, an architect may work on a set of plans for a building over multiple years, and deduct expenses well in advance of payment for the services.

There is no apparent basis for providing discriminatory treatment for authors in relation to other service providers. As the language of Section 263A clearly states, it is intended to reach persons that produce tangible property -- i.e., property other than a lawyer's brief or an architect's plans and specifications. Any decision by the Congress to extend the reach of Section 263A to the expenses of service providers should be deliberate and uniform.

## Revenue Implications

Although one can only speculate as to the amount of revenue that will be produced by this change in the tax treatment of authors' expenses, available information indicates that the amounts involved are small, if not trivial. Initially, it must be borne in mind that the issue is not the allowability vel non of deductions: the issue is any revenue loss resulting from deferral of tax collections. Two observations are appropriate: one, the group in question, professional writers, have extremely modest earnings; median income from writing is estimated to be $6,900 per year. Second, an exception to the uniform capitalization rules for such persons is not a loophole that might be exploited by the ingenious in order to gain an unintended advantage.

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[11] Commentators have observed that authors are properly characterized as receiving income from the sale of services, rather than from production of an asset. Note, Tax Treatment of Prepublication Expenses of Authors and Publishers, 82 Mich. L. Rev. 537 (1983). See also Hadley, supra.

## Conclusion

An exception should be provided to Section 263A for the research and writing expenses of professional authors.

The Authors Guild, Inc.

July 17, 1987

**PLAYBOY**

August 11, 1987

Congressman Dan Rostenkowski
Chairman
Ways & Means Committee
House of Representatives
Washington, DC 20515

Dear Congressman Rostenkowski:

As a full-time freelance writer, and at the urging of The Authors Guild, I'm writing you to ask that a clarification to the 1986 Tax Reform Act be made in the Technical Corrections Amendment Bill, stating that freelance authors' expenses in researching and writing a book not be subject to capitalization rules.

I was born and raised in Chicago and have lived here most of my life. I make my living as a freelance writer. Since April, 1982, I've written the monthly 'Men' column for Playboy, and I've published both a novel and a collection of short stories (in addition to other fiction and non-fiction in national magazines). If my expenses in researching and writing books is subject to capitalization rules, it could literally prevent me from undertaking important research and writing.

Any help you can give us would be deeply appreciated.

Sincerely,

Asa Baber
Contributing Editor

**PÈRGOT PRESS** • *1001 Bridgeway • Suite 227 • Sausalito, CA 94965 • (415) 332-0279*

7/21/87

Hon. Dan Rostenkowski, Chairman
Ways and Means Committee
2111 Rayburn House Office Building
Washington D.C. 20515

Dear Mr. Rostenkowski;

I am writing to ask you and members of the Ways and Means Committee to overturn the provision in a footnote in last year's tax law which could have a devastating effect on freelance writers and small publishers. The present law would:

- o deny almost all deductions for expenses incurred in researching and writing articles or books
- o deny any deductions for years when a project produces no income
- o allow deductions only against income from the project on which expenses were incurred.

Without action by Congress, I fear that our country's small presses and independent businesses will cease to exist, many bookstores will close, and a great national treasure will die because of a legislative error. To put the matter on a personal basis, I would have to give up years of work, research, and writing in the field of gerontology--a very urgent concern in the country today. I will not be able to develop important educational programs in a book to help the elderly increase their usefulness in today's society with techniques to decrease the potential for their becoming financial, medical, and emotional burdens on their families and the government.

I urge you to do what you can to revise the present footnote in the tax law. Thank you for your time and consideration.

Sincerely,

Margot Biestman

16 Round Hill Road
Lexington, Mass. 02173
July 14, 1987

The Hon. Dan Rostenkowski
Chairman, Ways and Means Committee
U.S. House of Representatives
Washington, D.C. 20510

Dear Mr. Rostenkowski:

As a writer and a member of the Authors Guild, I am writing to ask that a clarification be made in the Technical Corrections Amendment Bill, so that that a freelance author's expenses in researching and writing a book would not be subject to capitalization rules.

As you may know, the realities of the marketplace already make it exceedingly difficult for an author to make a living from writing. Under the average contract, almost all the proceeds from the sale of a book go to the publisher and middlemen; only about 10 % go to the creator of the book. The average author's income from writing in 1986 was about $7900. It seems ludicrous for the government to undermine that shaky foundation even more than the marketplace already has; and the return for the government, obviously, would be minimal.

I can speak especially for biographers, who may need anywhere from two to ten years to research and write a book: my own two took five and seven years, respectively. During that time the writer must invest a considerable amount of money from her or his own pocket. This is true even if one receives an advance or a grant.

Furthermore, as I understand it, Section 263A(b) would forbid a writer to deduct current expenses against the income from a previous book, although books are the product a writer produces, just as surely as a shoemaker produces shoes. It also requires a writer to spread deductions proportionately over the income-producing life of a work, although the life of any book is impossible to forecast. My first book, for example, was in print about four years, out of print another five, and now goes into a new printing: how was I to predict that pattern, and how am I to say how long the book will be in print this time?

Authors ask that the government give them the same recognition as self-employed doctors, lawyers and accountants, and allow them to deduct their ongoing expenses in exactly the same manner as members of those more lucrative professions.

Sincerely yours,

Paula Blanchard
Paula Blanchard

EDWARD CLINTON
5 LIBERTY STREET
CLINTON, CT 06413

Aug. 28, 1987

Dear Sir--

Why is it that when you finally get around to changing the tax laws, you pick on the writers?

Do you realize that the average book takes 2 years to write, and an *additional* two years to publish? On top of that, the average advance is under $3,000.00. In fact, 90% of all advances granted are under $10,000.00.

I have been a writer for twelve years and have yet to meet one person who could predict what novel, movie or television series would make money, much less *how much* a given project would make.

As usual, Congress picks on the weakest link in the chain. You ignore banks charging 18% interest on credit cards and go after writers who have to scramble around just to make ends meet.

Please *DO NOT* vote these changes into law.

Sincerely

Edward Clinton

**ROBERT CLYMIRE**
*Playwright*
3808 NORTH 14TH STREET
ARLINGTON, VIRGINIA 22201

August 1, 1987

Mr Daniel Rostenkowski
Chairman
Committee on Ways & Means
House of Representatives
2111 Rayburn Bldg
Washington, D.C. 20515

Dear Sir:

I'm concerned that Section 263A of the Tax Reform Act of 1986 may pose a serious hardship on independent writers and could greatly decrease the contribution of writers to American literature. For many of us, writing is already a labor of love. Please keep the few supports we have in place. I urge the Committee to correct the devastating impact the application of the uniform capitalization rules to independent writers will have when you consider the Technical Corrections Amendment to the Tax Reform Act of 1986.

Thank you.

Sincerely,
Robert Clymire

CULINARY AND FINE ARTS LTD.
Box 153, Western Springs, Illinois 60558, USA
Telephone (312) 246-5845

August 22, 1987

The Honorable Dan Rostenkowski
Congressman from Illinois
Washington, D.C. 20515

Dear Congressman Rostenkowski,

I am writing on a matter that concerns me, my colleagues, and all freelance writers. Please help us.

We request that a clarification be made in the Technical Corrections Amendment Bill, stating that freelance authors' expenses in researching and writing a book not be subject to capitalization rules.

As the wording stands, it is a threat to beginning writers who may never get their careers off the ground if this rule is enforced. It is a hardship to established writers who will be required to do an inordinate amount of bookkeeping. It is an **inequitable rule** in that authors will be the **only** self-employed businessmen who will be required to handle their expenses in a very complicated way and are denied Keogh plans and other benefits of self-employment.

We trust that your good judgement and sense of fairness will prevail in this matter.

Sincerely,

Camille J. Cook

Camille J. Cook

*Celeste N. De Blasis*
*Kemper Campbell Ranch • Victorville, California 92392*

July 29, 1987

Representative Dan Rostenkowski
Chairman/ COMMITTEE ON WAYS AND MEANS
U. S. House of Representatives
Washington, D. C. 20515

Dear Representative Rostenkowski:

I am writing to request that "a clarification be made in the Technical Corrections Amendment Bill, stating that freelance authors' expenses in researching and writing a book not be subject to capitalization rules."

The wording above is from The Authors Guild, but the belief in the necessity of the clarification is my own. I earn my living as a freelance writer. My novels take years of research and writing because I am very careful to make the historical backgrounds as accurate as possible. And because of the vast amount of material to be consulted and sites to be visited, I am always working on more than one idea, more than one era, always collecting and considering information. All of the books thus far written and all of those to come are part of me and part of my working life, not strangely separate machines or projects as The Uniform Capitalization provisions of the 1986 Tax Reform Act would make them.

The capitalization rules ( numbers 1, 2, and 3 in the enclosed Authors Guild letter ) are not only unjust, they are impossible to obey.

#1. The requirement that expenses be spread over the income producing life of the work is ludicrous. I have no way of determining that span of time. It is dependent on the publisher's actions in keeping a book in print or not and on reader demand.

#2. Similarly, the rule that in years when there is no income from a project, an author can take no deductions for expenses from that project. This is particularly inappropriate in its underestimation of the time and work involved, as if writers are making a set number of plastic widgets per year. Given the years my books take to write and considering that payment schedules in the publishing industry are odd indeed, this rule makes no sense. Again, I regard every year as a professional writer to be an investment in my career and in whatever works are in progress.

#3. And finally, the fact that expenses can be deducted only against income from the project for which they are incurred and not against total income from writing is grossly unfair and impossible. Sometimes subjects are pursued to add to general knowledge ( of the social and political trends of a certain century, for instance ) and will be used eventually in this or that or several novels. And sometimes ideas are pursued only to be abandoned when they prove inadequate to support a book. This ruling penalizes the very learning that makes books more interesting to readers. I have worked in lawyers' and doctors' offices and know that these professionals regularly receive costly printed updates regarding a vast number of subjects and take classes pertaining to law or medicine. An attorney might subscribe to thousands of pages of supplements for codes and cases, take the cost of those pages as a current expense, and yet only in the future or never at all use the information. And a doctor might take a class in some specialty, knee surgery for example, and yet he or she is surely not required to deduct that expense over the course of all the knee surgeries he or she will perform in a lifetime.

I would hate a life without books. They are a special part of human existence, created in a special way. I believe the least they and their creators deserve is common sense treatment under the tax codes. The capitalization rules are inapplicable to freelance writers, and the best they could accomplish is to make confused cheats of all of us.

With best wishes,

Celeste N. DeBlasis
CELESTE N. DE BLASIS

BARRY F. DILLON
3854 N. 2nd St. # 2
Arlington VA 22203

August 15, 1987

The Hon. Daniel Rostenkowski
Chairman, Committee on Ways and Means
House of Representatives
2111 Rayburn Building
Washington DC 20515

Dear Sir:

I am adding my voice to others of my profession who oppose the language of Section 263A of the 1986 Tax Reform Act.

I differ from many of our writing industry's leading proponents for change in the current Technical Corrections Amendment Bill in one regard: I am not trying to protect my already adequate profits from being properly taxed; I am trying to keep alive whatever chance I have of ever becoming successful in journalism.

I thank the Congress for trying to put a stop to "professional" writers who take boondoggles in order to circumvent taxation. I have known people in our profession who have made extensive travel and equipment purchases for write-off purposes. I don't. Early in my career, I worked for newspapers in entry-level positions. I struggled on criminally low wages. Since then, I've left working journalism for a career in public relations. Despite the poor odds of earning a good salary in journalism, I've kept my dreams alive by freelancing.

I am trying to get established with magazines by writing parttime. A project I worked on this summer should explain why I oppose the language of Section 263A. In January, my grandmother became terminally ill. After months of hospitalization and operations, I found out that a Flordia hospital had evicted her due to a provision in Medicare and Medicade. My family was torn apart trying to care for a helpless relative. I decided to pitch the story idea to a Florida magazine and they asked me to submit an article. So, I flew to Florida and on my vacation time wrote the article. The magazine, after editorial management changes and other problems, kept putting off the publication date until my grandmother died. Then, they told me they were not interested. I spent two weeks and a lot of money preparing the article. I received no compensation. As you know, Mr. Chairman, I will not be allowed to deduct those expenses from my taxes.

My feelings, in brief, are that the Congress should not allow people to abuse the tax laws to better pad their personal fortunes, it should allow people like myself -- freelancers -- to deduct legitimate expense and it should be honored for trying to cut out boondoggles.

Thank You,

Barry F. Dillon

6208 N. Campbell
Chicago, IL 60659
Aug. 11, 1987

Representative Dan Rostenkowski
U.S. House of Representatives
Washington, D.C. 20515

Dear Congressman Rostenkowski:

I am writing to you because you are Chairman of the House Ways and Means Committee. I am a freelance author. I have published four books and some thirty short stories in the last fifteen years. Under the new tax law, I will have to do some pretty complicated record- keeping and accounting. In some instances, I will not be able to deduct expenses applicable to a particular book because I won't be getting any income from that book in the year the expenses are incurred. This is unfair. Sometimes a book takes a year or two to research and write, and just as long (if not longer!) to sell. Writers live on the income from former work while they are producing future work; that is the nature of writing for a living. I am not paid now for the book I start today; I may not be paid anything for it for a year or two; yet I incur expenses related to that book, sometimes heavy ones.

A federal appeals court recently recognized the unfairness of this situation and struck down that section of the old tax law which dealt with this matter. Yet the new tax law contains an identical section, though now it has another number. Please see that the unfairness is removed from the new law and that the Technical Corrections Amendment Bill of the 1986 Tax Reform Act states that freelance authors' expenses in researching and writing a book not be subject to capitalization rules.

Thank you.

Yours sincerely,

Phyllis Eisenstein

Phyllis Eisenstein

BRUCE L. FELKNOR

August 20, 1987

The Honorable Dan Rostenkowski
Chairman, Ways and Means Committee
U.S. House of Representatives
Washington, D.C. 20515

Dear Chairman Rostenkowski:

Please lend your leadership and support to repair what I believe is unintentional damage done to writers in Section 263 of last year's Tax Reform Act. I believe that it, like the IRS interpretation of the old Section 280, is outrageously unfair to free-lance writers. Writing books is absolutely unlike producing movies or records or even publishing books, and authors should not be subject to the same expense capitalization rules as tax shelters.

I write not only as a resident and native of your state but as both an author and a publisher of considerable experience. My books include DIRTY POLITICS (1966, 1975, still in print and still the standard on election smear campaigns), THE U.S. GOVERNMENT: HOW AND WHY IT WORKS (1978, in English and Japanese), and the forthcoming HOW TO LOOK THINGS UP AND FIND THINGS OUT. As publisher, I have been assistant to Bill Benton, the late publisher of ENCYCLOPAEDIA BRITANNICA, and I am also the retired executive editor and director of yearbooks of the BRITANNICA.

Now my career is free-lance writing, and I can't afford the expense of an accounting department that can sift and allocate research costs to the seven books I am now working on. What's more, like almost all other authors, I have no basis for estimating either when or even if any of the seven will sell as many as 500 copies.

I urgently request your strong support and influence for a clarification in the coming Technical Corrections Amendment Bill that will exclude the research and writing expenses of free-lance authors from capitalization rules.

With thanks for your concern and warm good wishes, I am,

Sincerely,

EDITORIAL CONSULTANT
620 SMITH AVENUE LAKE BLUFF, ILLINOIS 60044 (312) 234-3094

August 13, 1987

Congressman Dan Rostenkowski
Chairman of the House Ways and Means Committee
Washington, D.C. 20515

Dear Congressman Rostenkowski:

We are requesting your support for the revision of the Tax Code which would allow authors to take expenses currently, rather than assigning them to writing projects which may generate income over some indeterminate period. The question has since been raised as to whether you and Senator Lloyd Bentsen, Chairman of the Senate Finance Committee, will allow the change to be made under the technical corrections bill currently being worked on.

Congressman Rostenkowski, this proposed change to the Tax Code has been upheld as the proper interpretation by the U.S. Courts and adjustment to the Code to rectify the problem is only a technical correction and would be relatively easy to make and noncontroversial. No one would deny that the writers of this country, the majority of whom earn less than $10,000 annually, should receive equal treatment with other independent business people. We are authors of some twenty children's novels and writing is our business. Any effort you can make to correct this onerous interpretation of the 1986 Tax Law through the technical corrections bill will be appreciated.

Yours truly,

James M. Haynes
James M. Haynes

Betty R. Haynes
Betty R. Haynes
4009 Deepwood Rd.
Colleyville, TX 76034

**NORTHWESTERN UNIVERSITY** COLLEGE OF ARTS AND SCIENCES

Department of Economics

2003 Sheridan Road
Evanston, Illinois 60201
Telephone (312) 492-5140

August 21, 1987

Dear Congressman Rostenkowsi

No doubt you have heard from most of the free-lance authors in Illinois by now. I am also an author, but I am writing to you as an economist now, and want your ear in that capacity.

One easily can understand why the expenses of a piece of capital machinery should be written off over the life of the machine against the machine's earnings. Commercial writing is not like that at all. No author has the faintest idea what his book might earn while he is writing it. Moreover, apart from the trivial advances against royalties he might get from a publisher, there are no earnings at all from a current book while it is being written. When the book is earning (if it does earn) there are no expenses, as the author will have turned to something else. This process is not analogous at all to capitalization of industrial machinery ~~at all~~, and whoever the bonehead is who wrote that footnote ought to be neutered --metaphorically speaking, of course.

Let me give you an example. One of your constituents, Allen Bloom, of the University of Chicago, has had a book on the best seller list for 14 weeks and stands to earn a nice chunk of money for it. When he wrote it he not only could not have estimated its income, his regular publisher estimated it at nearly zero and refused to publish the book at all. How would Bloom have estimated the income of that book against which to apply his expenses? What if the book had failed? Are we to say, tough luck old chap, stop writing books and get into something that pays, like Chicago politics?

I know that Congress is desperate to raise more tax money, it always is. But this idea is a bad one. It won't raise enough tax money to pay the salaries of the bureaucrats who audit the returns, and will discourage the development of the country's culture, which isn't exactly flourishing as things are now.

Sincerely

Jonathan Hughes
Professor

# Book Battle: Change in Tax Deductions Rouses Fury of Authors and Publishers

YOUR
MONEY
MATTERS

By Barbara Rosewicz
*Staff Reporter of* The Wall Street Journal

Authors and book publishers are demanding a correction—in the new tax law.

Julia Child is so upset that she took time out from writing her latest cookbook to write her congressman. Robert Massie says he couldn't have written his Pulitzer Prize-winning book, "Peter the Great," under the new law.

"My tax accountant has urged me to quit writing children's books," complains LouAnn Gaeddert, a Canaan, N.Y., housewife who earns $5,000 to $10,000 a year penning works like "Noisy Nancy Norris."

What has upset the publishing world—from struggling free-lance writers to the biggest publishing houses—is a last-minute footnote in an 886-page conference committee staff report accompanying the 1986 tax act. The footnote zaps publishers and unsalaried writers where it hurts most: in their tax write-offs.

### Spreading Out Deductions

Until now, publishers, authors, screenwriters and the like have deducted all their legitimate expenses for research and writing as the expenses were incurred. But under the staff's interpretation, which lawmakers never actually debated, books—and perhaps, tax lawyers say, songs, poems, manuscripts and photographs—are to be treated for tax purposes more like manufactured goods. Consequently, deductions for production costs would have to be deferred until the inventory is sold, forcing most writers to do complicated accounting and income-forecasting calculations and reducing the value of their write-offs.

Book publishers and the 6,500-member Authors Guild argue that the footnote doesn't carry the weight of law, and they may be willing to argue that in a legal challenge. But with that issue in doubt for now, opponents are lobbying Congress for remedies.

"The most seriously affected are beginning authors," says Helen Stephenson, executive director of the Authors Guild. "But every single author is a different case. A Julia Child who has to amortize her oregano is different from a J. Anthony Lukas. We find that even established authors can be killed on this."

If the change sticks, most writers will have to separate direct costs like travel expenses for each book, article, speech, poem or song they are working on, as well as divide overhead expenses among the projects. Then they would have to amortize the expenses for each work, deducting only a portion of the expenses in each year they get income from the work. If a project doesn't yield any income in a given year, tax lawyers say, its deductions would have to be carried forward.

In the worst case, tax lawyers have told authors they may have to give up their copyright on books, songs or articles that flop if they want to take pent-up tax deductions from a project that hasn't produced income. Government lawyers doubt that would be necessary.

Defenders of the footnote argue that it makes sense as tax policy. Why, they ask, should wealthy, best-selling authors get substantial tax deferrals while mom-and-pop manufacturers, for example, can't? "As a rule of taxes, it's a good rule, because you don't want people taking deductions before they get the income," says one congressional aide. "It's the time-value-of-money principle."

> 'IT JUST SEEMS to be bad public policy for the tax law to encourage quick, exploitive work as opposed to long, serious work,' says one author.

But the Authors Guild argues that the median income of free-lance authors is only $7,900; according to a 1980 study, just 4% of authors had incomes over $100,000. And, the guild says, IRS rules already prevent hobbyists from abusing the tax code to deduct private trips or expenses.

Many best-selling and other authors are pressing Congress to throw out the footnote. Mrs. Child says she fears she may lose some of her tax write-offs for business expenses like culinary trips to Paris and makeup sessions. "I'm over 29, you know, and I can't appear on TV without any makeup," she says. "That's $100. If I can't write that off as a business expense, I couldn't afford to do it."

Deeply affected would be writers who spend extended periods researching and writing a book, who might have to wait years to deduct the bulk of their expenses. Mr. Massie says "Peter the Great" required seven or eight trips to Russia for research and took him 12 years; in some years he received no advance money and so couldn't have deducted expenses under the footnote. "I couldn't have written that book under these rules," he says.

Mr. Massie and other authors say the tax change could even influence the kind and quality of books being written; a writer who couldn't command a big advance could recover expenses much faster from a sensational, fast-selling book than from a well-researched volume with a long shelf life. "It just seems to be bad public policy for the tax law to encourage quick, exploitive work as opposed to long, serious work," says Mr. Lukas, who spent 7½ years researching and writing "Common Ground," which traced three families in Boston and won a 1986 Pulitzer Prize.

### Important Ally

Footnote foes may have a better chance of winning their fight than most other lobbyists pressing for technical corrections to the tax act. They already have an important legislative ally in New Jersey Democratic Sen. Bill Bradley, one of the prime movers behind the tax-overhaul effort, who himself wrote a best-selling book on his basketball days. At a recent hearing, Sen. Bradley said: "Wherever this footnote came from and whatever its intent, I certainly don't think it should apply to authors. It is fairly onerous to try to make the case that something like a poem is a tangible piece of property."

Book publishers, who are subject to the same basic limitations as authors under the disputed footnote, are taking a somewhat different tack. If they must be treated like other manufacturers, they argue, then they should be able to deduct research and development costs just like other businesses, at least for the costs of developing textbooks and other educational, professional and reference works.

Publishers' research and development costs represent an old unsettled question with the tax collectors. Publishers contend they're hurt most by being unable to deduct their costs each year in developing works like textbooks and reference works, which require long lead times and lots of experimentation and have long shelf lives. For example, Random House spent $9 million over 20 years to prepare a revised edition of the Random House Dictionary. Under the new law, the firm might not have started deducting some of those expenses until the dictionary reached bookstores.

Mortimer Caplin, counsel to the Association of American Publishers and a former IRS commissioner, says the change will "add to the cost of doing business, and publishers will be less likely to innovate, to take chances on borderline books."

8/7/87

*Elizabeth Watkins Jorgensen*
*Henry Irvin Jorgensen*
*317 Alder Street*
*(408) 372-3209* *Pacific Grove, California 93950*

August 15, 1987

The Honorable Dan Rostenkowski
U.S. House of Representatives
Washington, D.C. 20515

Dear Congressman Rostenkowski:

As biographers of a distinguished American, we are urging you to support a change in the Tax laws that will eliminate an unjust burden on the serious authors of this country.

The problem is that the Revenue Code treats writers as if they're equipped with a battery of tax accountants and lawyers, are making money hand over fist and are tossing off books in their spare time so as to create fictitious tax losses that will offset the high incomes they make from their "real" activities.

Our biography was published by Grove Press, New York, in 1985. It was called Eric Berne, Mastergamesman, We had spent eight and a half years researching it and travelling all over the country interviewing people who knew Berne. We also poured a lot of our retirement income into it, because it made a statement about the man who developed the "I'm OK --- You're OK" theory --- a statement of some importance. A long review in the Clinical Social Work Journal (copy attached) concurs.

It will take a while for the public to catch on to its importance. As the tax laws are now being interpreted, we can't offset any of these costs against our current income, but only against profits from the book each year. It may take a generation for this book to pay off, but by that time, we may well be gone and our losses never accounted for.

The tax laws should encourage writers to take risks to increase the sum of human knowledge.

SO:

As Chairman of the House Ways and Means Committee, you will undoubtedly give this careful consideration and we trust you will agree that there should be a clarification to the 1986 Tax Reform Act in the Technical Corrections Amendment Bill, so that freelance authors' expenses in researching and writing a book will not be subject to capitalization rules.

Yours truly,

Elizabeth Watkins Jorgensen

### ERIC BERNE: MASTER GAMESMAN, By Elizabeth Watkins Jorgensen and Henry Irvin Jorgensen New York: Grove Press, Inc. 1984 $9.95 p.b.

Eric Berne was a pioneer in the movement to demystify psychotherapy. He invented a theory of personality and a method of treatment which invited the client to enter into partnership with the therapist in the treatment process and he named his sytem Transactional Analysis (T.A.). T.A. is an existential approach to human behavior emphasizing contracts for social performance and responsibility for decision making. Berne's existential dictum was the decision to be O.K. rather than not O.K. In order to be O.K. one stops exploiting personal relationships to satisfy neurotic grudges. Berne named these neurotic transactions "Games" and his now famous book, *Games People Play*, stayed on the best seller list for 200 weeks.

As his biographers tell, Berne was not as fortunate at giving up Games in his personal life as were the many beneficiaries of his knowledge. Elizabeth and Henry Jorgensen, the authors of this biography, are lay persons who had only peripheral contact with Berne and their eight year work to research the details of his life is a testimony to the charismatic appeal that drew people to Berne. The Jorgensens interviewed more than 200 people to obtain the facts of Berne's life and their findings make a readable "transactional biography" as well as an Ibsensque drama about a therapeutic genius. A fiercely competitive man who would leave a legacy of both accomplishment and disappointment, Berne founded the International Transactional Analysis Association which, during the last 10 years of his life, grew to a membership of 10,000. ITAA books, which Berne and his associates wrote, have sold more than 25 million copies in English and foreign translations, and T.A. theory is firmly established in the literature of psychotherapy.

The disappointment in Berne's life was that, with all the fame and support which came to him, he failed to achieve the intimacy which he coveted in others. A lonely and self-tortured individual, he struck out at people who came close to him. As the authors point out, Berne understood the principles of neurotic games because, as one of his wives reported, he had played them all. But his thinly disguised pathos was also a quality that bound people to him and was the source of his insight into human suffering.

The authors have covered three sides of Berne's personality—his relations with three wives and peripherally with other women, childhood in the Montreal Jewish community, and relations with professional associates. Important information on Berne's childhood came from his own unpublished stories. The birth of a sister when Berne was five was a disturbing event for him and he responded by cutting up a rubber sheet that he found in the basement. His father's punishment, 20 strokes with a razor strap, so indelibly impressed upon him the consequences of being a bad boy that, even in his fifties, he used to mutter to himself, "bad boy," when things went wrong. An outsider with his school peers, he was derided as Crazy Lennie, an epithet that he went out of his way to validate with bizarre antics. In T.A. terms the name of the game is Kick Me.

Berne studied fairy tales as a source of behavioral wisdom and in his own relations with women he repetitively reenacted the sacrificial redemption of the lost child. The theme was: If you love me enough to endure my outrageous treatment of you, you will save me from myself. On the day before his second marriage he begged his first wife to take him back and on the eve of his third marriage he asked his second wife to marry him again. Without exception, however, no woman's kiss was able to turn Berne's *frog* into a prince charming.

To the professional associates who gathered around him during the last ten years of his life, Berne was a brilliant, but enigmatic and aloof, teacher. This fact was painfully realized after his death by one of leading proteges, Claude Steiner, who said, (pg 7), "I find it inconceivable that he shouldn't write a will and not mention in some way just something—about his most devoted disciples . . . I'm not saying he should have left anything valuable, but some remembrance, something that connects you up." This desire to share in pathos and be "connected up" to other humans must be a vital element in the character of a therapist. The Jorgensen's biography has told the story of those who were connected to Eric. The mystery which remains unexplained is, in T.A. terms, the lack of congruence between Berne's competent Adult, mean spirited Parent and wounded Child.

David G. Edwards
Hollister, CA.

ean associates, inc.

August 12, 1987

Rep. Dan Rostenkowski
US House of Representatives
Washington, DC 20515

In the interest of fairness, I would like you to please vote, YES, on a clarification to the Technical Corrections Amendment Bill, stating that freelance authors' expenses in researching and writing a book not be subject to capitalization rules.

Thank you.

Ed Kolaczyk

Anne Kolaczyk

21721 North Hampton Court, Kildeer, Illinois 60047 • (312) 438-6099

Aug. 6, 1987

William G. Kroger
108 E. Bellefonte Ave.
Alexandria, VA 22301

Honorable Dan Rostenkowski
Chairman
Ways and Means Committee
U.S. House of Representatives
Washington, DC 20515

Dear Chairman Rostenkowski:

I make my living as a free-lance writer, and it has come to my attention that a proposed change--a footnote to the Tax Bill, which applies to the Uniform Capitalization provisions of the revised law (Section 263A)--may bar writers from deducting their book-writing expenses in the year these expenses take place. This footnote places books in the same category as other "tangible property," such as cows and refrigerators, for the purpose of deductions.

Specifically, the proposed changes will make it financially impractical for many authors--including me--to write books, because writers will:

1. Not be able to take deductions for book-writing expenses in the years that the writer earns no income for that book;
2. Lose almost all current deductions for expenses for researching and writing books, by having to spread these deductions proportionally over the income-producing years of the book; and
3. Be able to deduct expenses only against income from the particular book and not against total writing income.

In short, writers will become the only self-employed category of workers who are unable to deduct their normal business expenses. I cannot believe Congress wishes this to happen.

I urge that a clarification be made in the Technical Corrections Amendment Bill, stating that free-lance authors' expenses in researching and writing a book not be subject to capitalization rules.

I thank you for your time and attention on this important issue.

Sincerely,
Bill Kroger
William G. Kroger

**MICHAEL P. KUBE-McDOWELL**
*Freelance writer*
*Member SFWA, WGA-East*

P.O. Box 506
Okemos, MI 48864-0506
(517) 394-5396

September 1, 1987

Dan Rostenkowski, Chairman
House Ways and Means Committee
1102 LHOB
Washington, DC 20515

Dear Mr. Rostenkowski,

I am writing to plead for mercy -- to urge that you incorporate in the upcoming Technical Corrections Amendment for the 1986 Tax Reform Act an exemption for authors to the capitalization of expenses requirement.

I'm a self-employed unincorporated free-lance writer with five books in print. Like most of the writers I know, I have no tax advisor, no accountant, no attorney -- just an agent who tries to sell my books and a publisher who's been willing so far to buy them. In a very real sense, I'm all alone out here, scrapping to support myself and my son on earnings fluctating between $15,000 and $30,000 a year.

Earlier this year, I breathed a deep and heartfelt sigh of relief at the news that the Judge James Oakes and the Second Circuit Court of Appeals had struck down the "Garrison decision" requiring authors to capitalize expenses. As I believe you are aware, the IRS tried to require authors to hold off deduction of the basic expenses of writing a book until that book begins to produce income, and then to capitalize those expenses over the "earnings life" of the book.

But I have since learned that my relief was premature, and that the new tax law contains exactly the same requirement!

As a matter of fairness, why should a writer be treated differently than any other self-employed person -- an taxi driver, a retailer, a plumber, a beautician? If we use cash basis accounting, we deduct expenses when incurred and claim income when constructively received. Simple, direct, and reasonable. The time lapse between completing a book and seeing it on the stands can be as long as two years, which is hardship enough without having to carry an account of undeductable expenses.

As a matter of practicality, how can it be done? I keep meticulous records, and yet I can say flatly that it would be an impossible task for me to comply with such a requirement. The "expenses" under discussion are things like the rent on my office, maintenance on my office equipment, paper, envelopes, postage -- I can't begin to see how to allocate them among various projects.

Moreover, there is no way to know in advance the "earnings life" of a given book. Nothing is more unpredictable than how long a book will remain in print and continue producing (usually a trickle of) income. The nature of the business simply does not allow for that kind of knowledge. Any attempt to specify an earnings life must necessarily be a very wild shot in a very dark room.

But the most important point was made by Judge Oates in his ruling. The IRS erred in lumping writers together with motion picture producers and the like: "Authors are not engaged in the production of books -- book publishers are. Authors, rather, create the stuff of which books are made; they write manuscripts."

Your desire to control abusive tax shelters is commendable. But we are not abusing the law or the public by deducting our expenses when we incur them. The real abuse would be to deny writers the right to conduct their financial affairs the way other self-employed persons do, or to drive writers from the profession through onerous and unreasonable regulation. This is not a plea for special treatment -- only for fair and equitable treatment.

I urge you most earnestly to make this change part of the TCA.

Sincerely,

Michael Kube-McDowell

Michael P. Kube-McDowell

GREENER PASTURES PRESS, INC.
1828 BOLTON STREET
BALTIMORE, MARYLAND 21217
301 • 383-6295/6296

8/16/87

Daniel Rostenkowski
Committee on Ways & Means
House of Representatives
2111 Rayburn Building
Washington D C 20515

Dear Mr. Rostenkowski:

Please change the Technical Corrections Amendment. The application of the uniform capitalization rules to independent writers as appears to be required by Section 263A of the Tax Reform Act of 1986 will work a serious hardship on writers and could discourage many writers from undertaking artistic efforts. I urge the Committee to correct the devastating effect of application of this rule to writers when the Committee considers the Technical Corrections Amendments to the Tax Reform Act of 1986.

Sincerely,

Barbara [illegible]
Member, WIW

THE
CHAPEL
OF THE AIR
BOX 30, WHEATON, ILLINOIS 60189-0030 • PHONE 312/669 7292
BOX 2000, WATERDOWN, ONTARIO, CANADA L0R 2H0
David R. Mains, Director

August 31, 1987

Dan Rostenkowski, Chairman, IL
Ways and Means Committee
U.S. House of Representatives
Washington, D.C. 20515

Dear Mr. Rostenkowski:

As a best-selling and prize-winning author, and a broadcaster heard daily over 500 outlets nationwide, I would like to express my concern about the 1986 tax reform act, and ask that a clarification to this act be made in the technical corrections amendment bill stating that freelance authors' expenses in researching and writing of books not be subject to capitalization rules.

Two of my works, one on child sexual abuse and the other on the refugees in the world took several years to research and to visit camps all across the countries of Asia, Africa, and the Near-East and as well as doing extensive interviewing work with refugees for the book, The Fragile Curtain and for victims and survivors of child sexual abuse for the book, Child Sexual Abuse: A Hope for Healing. The laws as they exist or potentially are interpreted could be of unusual hardship to authors who are caught up in this kind of project, some of which require many more years of research than these two required of me.

I would appreciate and would strongly recommend that the free lance author be considered as an exception to these capitalization rules. I am expressing my opinion in this letter in the hope that you will add it to the legitimate protests of many others who, I know, feel as strongly as I do about this topic.

Sincerely,

Karen Mains

Karen Mains

1844 Columbia Road NW #304
Washington DC   20009

5 August 1987

The Honorable Dan Rostenkowski
Chair
Committee on Ways and Means
US House of Representatives
Washington DC   20515

Sir:

The application of the uniform capitalization rules to independent writers, as appears to be required by Section 263 A of the Tax Reform Act of 1986, will work a serious hardship on writers and could discourage many writers from undertaking artistic or business efforts. I urge the Committee to correct the devastating effect of application of this rule to writers when the Committee considers the Technical Corrections Amendments to the Tax Reform Acto of 1986.

Sincerely,

David C. McCaughey

---

421 Rosewood Avenue
Winnetka, IL 60093
August 12, 1987

The Honorable Dan Rostenkowski
Chaiman, Ways and Means Committee
United States House of Representatives
Washington, DC 20515

Dear Mr. Rostenkowski:

I respectfully request that you support a clarification in the Technical Corrections Amendment to the 1986 Tax Reform Act to assure that free-lance authors' expenses in researching and writing a book not be subject to capitalization rules.

I am a free-lance writer of books and articles and a member of The Authors Guild.

Sincerely yours,

Helen J. McLane

Helen J. McLane

Anne Meadows
100 10th Street, S.E.
Washington, D.C. 20003

(202) 544-6541

July 25, 1987

Hon. Dan Rostenkowski, Chairman
Committee on Ways and Means
U.S. House of Representatives
Washington, DC 20515

Dear Rep. Rostenkowski:

As a freelance writer, I am concerned about how the proposed "Technical Amendments" to the 1986 Tax Reform Act will affect my ability to earn a living.

For the past year and a half, another writer and I have been working on a historical project entailing a great deal of time and expense for research. Because commitments from publishers for this type of project are nearly impossible to obtain before the work is undertaken, we have borne the expenses ourselves, using money earned from other projects. Thus far, we have sold one magazine article on our topic for $500--far less than our expenses to date. A newspaper syndicate has expressed interest in a three-part series, and we are confident that when our research is complete--at considerable additional cost--we will find a publisher for our book. If we are lucky, a big-name publisher will take the book and promote it to best-sellerdom. More likely, a university press will wind up publishing the book to fill a gap in the information currently available to scholars. Naturally, we hope to make money, but we will be satisfied if we break even, because the project is worthwhile.

If Congress amends the tax law to require us to capitalize the expenses of researching and writing our book, however, we may have to abandon the project. Writing is probably the most underpaid profession in the nation. Considering the level of skill and the amount of time good writing requires, the pay is pathetic. My income is more than triple the national average for full-time freelance writers, and yet I will be lucky to gross more than $25,000 this year. (That includes no health or life insurance, no sick leave or annual leave, and no employer contribution to social security, retirement, or unemployment compensation.) I can't afford to capitalize any more of my expenses than I already do.

Please include language in the Technical Corrections Amendment Bill specifying that writers' expenses for researching and writing books are not subject to capitalization rules. Allow us to deduct expenses in the years we incur them and to deduct expenses against income from other projects. We do not operate on a scale that would permit us to do otherwise.

Sincerely,

Anne Meadows

Anne Meadows

August 3, 1987

David G. Mudd
2022 Columbia Road NW, Apt. 616
Washington, D.C. 20009

Honorable Dan Rostenkowski
Chairman
Committee on Ways and Means
U.S. House of Representatives
Washington, D.C. 20515

Sir,'

I am a freelance writer and am writing to urge you to see to it that a clarification is made in the Technical Corrections Amendment Bill, stating that freelance authors' expenses in researching and writing a book not be subject to capitalization rules.

I understand that a relatively minor oversight has produced the situation we now have, where an author cannot deduct the expenses of writing and researching a book as business expenses. It's a minor oversight that could lead to great hardship on the part of many who choose to write for a living. That is certainly not what was intended by the bill.

I hope you will do all you can to forge this clarification.

Thank You,

David G. Mudd

NWC The National Writers Club
1450 South Havana • Suite 620 • Aurora, Colorado 80012 • 303/751-7844

A Non-Profit Organization
Founded in 1937

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Nance Moore
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Rex Alan Smith

Founder
DAVID RAFFELOCK

August 21, 1987

The Honorable Dan Rostenkowski,
Chairman, Ways and Means Committee
U.S. House of Representatives
Washington, DC 20515

Dear Representative Rostenkowski:

As Executive Director of the National Writers Club and Associated Business Writers of America, and on behalf of our 5,000 members nationally, I am writing to you concerning the provisions of the 1986 Tax Reform Act relating to uniform capitalization, which we perceive is harmful to authors.

We urge you to use your influence in making a clarification in the Technical Corrections Amendment Bill, stating that freelance authors' expenses in researching and writing a book not be subject to capitalization rules.

If the provision is allowed to stand, it will endanger the occupation of multitudes of book writers, since they will lose virtually all deductions of expenses from writing and researching of books. They will be forced, instead, to spread such deductions proportionately over the income-producing life of the work. It would almost impossible to make such forecasts.

To make things worse, in years where there is no income from a book, the author will not be allowed to take any deductions from that work, even though most of the research and related expenses would have been incurred prior to the work's publication. Plus, expenses can be deducted only against income for the particular project for which they were incurred and NOT against the author's total writing income.

We're sure you're already aware that freelance writers have a difficult time; if imposed, these additional handicaps will cause a drastic decline in the number of serious authors.

We appreciate your concern and appreciate your assistance.

Sincerely,

James L. Young

James Lee Young,
Executive Director,
National Writers Club &
Associated Business Writers
of America

Bonnie Larkin Nims
3820 Lake Shore Drive
Chicago, Illinois 60613

August 25, 1987

Dear Congressman Rostenkowski,

I am writing for my husband, John Frederick Nims, as well as myself – we are both published writers – to ask that the so-called "footnote" clause in the new tax bill be eliminated.

This clause, which severely restricts business expense deductions for writers, is unfair in that it requires the writer to be always producing – with no time out for the planting or ripening of thoughts or plots. "Footnote" is also economically unsound: A penny saved is a penny saved but a penny invested is a penny multiplied.

I am proud of the district that elected you as their congressman, and I hope that you will re-evaluate and rescind this disturbing and destructive clause.

Sincerely yours,
Bonnie Nims

**Peter J. Ognibene**
1127 Cresthaven Drive
Silver Spring, Maryland 20903-1607
(301) 434-9449

August 7, 1987

Hon. Dan Rostenkowski
Chairman
Committee on Ways and Means
U.S. House of Representatives
Washington, DC 20515

Dear Mr. Chairman:

I write to urge you to include in the Technical Corrections Amendment Bill a clarification that would treat the expenses of freelance writers in a reasonable way. The law, as I understand it, would not permit deductions for normal business expenses in the year they are incurred. They would have to be capitalized over the years the "work" produced income.

I have been a writer since 1970 and have had a biography, novel and several hundred articles published. My financial strategy -- and it is one common among freelance writers -- is to use the money I receive from one project to finance the next. My novel, *The Big Byte*, was financed largely by magazine articles written between 1981 and 1983. The manuscript of the novel was accepted for publication in March 1983 but was not published until July 1984. I cite these dates to give you some idea of the gestational gap between the conception of an idea and its actual delivery.

Writers sell their work, and in that sense, we are like other businesspersons. Where we differ from other sellers is that our real product is of the imagination; the paper on which it appears is the form of expression, not its content. The true product is exists in the author's imagination.

A reasonable distinction between writers and "literary hobbyists" must be made so that individuals do not escape taxes by claiming to be writers and deducting unreasonable expenses to offset other income. However, when a person's earnings as a writer make him or her a taxpayer, I believe they should be able to claim reasonable expenses against current income as they work to develop new "products."

Sincerely,

JANICE POTTKER
10104 Lloyd Road
Potomac, Maryland 20854
(301) 762-3519

The Hon. D. Rostenkowski, Chair
Comm. on Ways and Means
House of Representatibes
2111 Rayburn , D.C.

Aug. 3, 1987

Dear Mr. Rostenkowski:

I am concerned that Section 263A of the Tax Reform Act of 1986 will mean that uniform capitalization rules will apply to independent writers. If so, many of us will no longer be apply to afford to continue writing and publishing. If free-lance writers cannot deduct ordinary and necessary business expenses (differentiating us from all other self-employed people), we will not be able to continue to write. For example, I am publishing my third book this fall. Since the work on that book has been completed, I am drafting proposals to send to editors for other books. However, if I do not eventually publish each of these books for which I have submitted proposals, I will be unable to deduct any of my necessary expenses. Yet it is unrealistic to assume that each book proposal will be accepted by an editor at a publishing house. Writers usually send up several trial balloons before an editor catches one. This is considered necessary and appropriate in the publishing business. Without being able to deduct the research costs of each book proposal (and my research costs for my upcoming fall publication totalled in the tens of thousands), free-lance writing will become an impossibility for all but a handful of celebrity writers.

Please reexamine the rule to writers under the Technical Corrections Amendment to the Tax Reform Act. Thank you.

Sincerely yours,

(Janice Pottker, Ph.D.)

Route 2 Box 304
Otis, Oregon 97368

August 24, 1987

Representative Dan Rostenkowski
Chairman, House Ways and Means Committee
United States House of Representatives
Washington D.C. 20515

Dear Representative Rostenkowski,

I'm not one of your constituents, but I'm writing to you because your committee is considering a bill that could have a disastrous effect on my life. Enclosed is a copy of a letter I sent to Senator Lloyd Bentsen, Chairman of the Senate Finance Committee, which will explain my deep concern for S. 1350, the Technical Corrections Act of 1987. (I'm sorry, I don't know the number of the House's companion bill.)

I wrote to my Representative, Les AuCoin, and to both my Senators, Bob Packwood and Mark Hatfield, about including a clarification in the bill stating that authors expenses in writing and researching a book should not be subject to capitalization rules. Yesterday, I received a reply from Senator Hatfield, and he suggested that I should write to all the members of the Senate Finance Committee and of the House Ways and Means Committee. Rather a daunting task, since there are a total of fifty-six people on the two committees. That's why I've resorted to sending copies of my letter to Senator Bentsen to the members of the committees. I hope they will understand my difficulty and will consider my comments seriously, even if they are presented as a copy of a letter. What I have to say is vitally important to me, of course, and to all authors of books. We are a small group, most of us far from rich. Poor, in fact. But we need help. I hope you will offer it.

Thanks,

Martha Kay Renfroe

Martha Kay Renfroe
(M. K. Wren)

Route 2 Box 384
Otis, Oregon 97368

COPY

August 24, 1987

Senator Lloyd Bentsen
Chairman, Senate Finance Committee
United States Senate
Washington D.C. 20510

Dear Senator Bentsen,

I make my living as an author, and over the last fifteen years I've had nine books published by Doubleday and Berkley. I'm writing to you now about S. 1350, the Technical Corrections Act of 1987.

Recently, I was alerted by Authors Guild that the new Tax Reform Act of 1986 includes under section 263 the requirement that people in certain professions -- *including* authors of books -- must use "uniform capitalization rules" in calculating their business expense deductions.

Writers generally are not CPAs, and the accounting nightmare that would be imposed on book writers by section 263 constitutes unusual and inhumane treatment. Beyond that, I think you should understand that it asks the impossible. Not just the difficult, the *impossible*. Writing is a risky and totally unpredictable business, especially book writing. An author can work for years on a manuscript and have absolutely no guarantee that the manuscript will be published as a book at all. And if it is, the author has no way of knowing whether the book will be a blockbuster or a bomb. Nor does the author have any way of predicting whether the book will be chosen as a book club selection, published in foreign countries, or reprinted years later. Writers generally are not clairvoyant any more than they are CPAs.

Yet this is what section 263 will require of us -- to be both CPAs and clairvoyants -- if we hope to deduct our justifiable business expenses. And if we can't be clairvoyant CPAs, then we simply can't deduct those expenses. Writers as a whole don't make much money (five to seven thousand dollars annually on average), and we can't afford to pay taxes on our *gross* income. And it doesn't seem reasonable or fair that we should be required to do so.

Therefore, I beg of you, before S. 1350 leaves your committee, add a clarification stating that freelance authors' expenses in researching and writing a book *not* be subject to capitalization rules.

I'm sending copies of this letter to the other members of your committee and to the members of the House Ways and Means Committee. And I would add to all those people: Writers aren't asking for special treatment when it comes to taxes. We'd all move to Ireland, if that were the case. All we ask is to be treated fairly.

Sincerely,

Martha Kay Renfroe
(M. K. Wren)

Richard Severo
81 BALMVILLE ROAD, NEWBURGH, NEW YORK 12550 (914) 561[redacted]58

August 10, 1987

Representative Dan Rostenkowski, Chairman
House Ways and Means Committee
United States House of Representatives
Washington, D.C.

Dear Congressman Rostenkowski,

I enclose herewith a copy of a letter I have sent today to Senator Daniel P. Moynihan, who is a member of the Senate Finance Committee. To you I respectfully address the same questions I have addressed to Senator Moynihan regarding the Tax Reform Act of 1986 and its devastating effect on writers in this country. I find it hard to believe that this is what you intended. I look forward to hearing from you.

Many thanks.

Sincerely,

Richard Severo

Richard Severo

---

Richard Severo
81 BALMVILLE ROAD, NEWBURGH, NEW YORK 12550 (914) 561-3238

August 9, 1987

Senator Daniel Patrick Moynihan
Member, Senate Finance Committee
United States Senate
Washington, D.C. 20510

Dear Senator Moynihan:

I have heard it suggested that writers are really not very bright and that they are possessed of an inordinate and tiresome need to have the real world explained to them. I am writing to you since you are a United States Senator and, I am quite confident, have overcome all the shortcomings associated with being a writer. You may thus be able to help me better understand the Tax Reform Act of 1986. For it seems to me that this "reform" is quite destructive to me and to every other serious writer in this country who is productive but not on the best-seller list. Please let me briefly give you the impact of this "reform" from my perspective.

For the past three years, I have been working very hard on a work of social history which deals with how American soldiers have been treated after wars, from the Revolution to Vietnam. I have now written more than 100,000 words. The manuscript is due at the publisher's next February. I got the idea for it from covering the Agent Orange issue in the late 1970's for The New York Times. With my collaborator, Lewis M. Milford, I signed a contract with Simon & Schuster, calling for an "advance" of $26,000 - $13,000 of it payable at the at the beginning of our research, $13,000 paybe if and when S&S accepts the completed manuscript. Less 10 percent to our agent, of course.

So, as will be very clear to any and every clerk at the Internal Revenue Service, Milford and I each received a tad over $6,000 apeice, which we were to use to pay our expenses in research over the three-and-a-half years it would take to create the book. That works out to about $1,714 a year for each of us. In other words, we essentially agreed to write a major work of American history and social criticism for nothing.

In order to research this book, I have travelled to the Army War College in Carlisle, Pa.; to various and sundry public and university libraries in New York City; to the library of the United States Military Academy at West Point; to the Adriance Library and the Vassar College Library in Poughkeepsie; to the Jones Library in Amherst, Massachusetts; to the Springfield, Mass., public library; and to the library here in Newburgh. Milford has done his research in New York, Newark, N.J.; New Brunswick, N.J.; Hanover, N.H.; Boston, Mass.; and elsewhere.

We have both purchased thousands of dollars worth of books, magazines and newspapers. We have interviewed scores of people by telephone and have run up large bills. We have attended scholarly conventions. We have spent shameful amounts of money in excess of our advance, on meals, hotel rooms, on computer expenses, paper, postage and a myriad of other items. We did it because we thought, perhaps naively, that our fellow Americans might be interested in what we have learned about a neglected aspect of American history. And yet, although I have purchased no two-martini lunches for anyone in all this time, I have been audited by the IRS, and warned that I cannot deduct any of the above unless I show "income." But there is no income from a book that is in the process of creation.

I should insert here that I am also the author of Lisa H., which was published in 1985 by Harper & Row and paperbacked last year by Penguin. I have won 28 awards in journalism, including the George Polk award, and been nominated for four Pulitzer prizes. My articles have appeared in The Nation, The Reporter and The New Yorker. My write-up in Who's Who, for all that is worth, lists me as a "writer." And although it may be that many of Americans have never heard of me, many others have. In any event, I do not think any reasonable person would accuse me of being a "hobbyist," of being a person who is not serious about writing and only dabbles in it. I am very serious about it. It is just that I do not make very much money, not even at the ripe old age of fifty-four. And that seems to be what the I.R.S. has against me and writers like me.

America is hardly awash in serious readers. Lew Milford and I very much want our soldiers book to make the best-seller list, we have no guarantee that this is going to happen. In the interm, we have had to subsidize the research period heavily. He works as a lawyer. I am on leave without pay from The Times, not to return before next spring, but I earn a pittance from teaching in the American Culture program at Vassar College. I make up the shortfall from my own savings. I never saw anything wrong with that. I hardly think it is un-American or deserving of contempt from an elected or appointed official or from the Federal cadre of civil servants.

But now, Government of the United States has apparently taken the position that people like me, no matter how hard we work and no matter how lofty our objectives, are only "hobbyists," that we are frivolous and apparently not deserving of the deductions that are enjoyed by virtually every other American who risks his time and money to earn a living. Although my last book received rave reviews and I am taking a considerable financial risk in writing this book and hoping to make something on it, my Government is telling me that the risk I take is somehow not as exalted as the risk taken by somebody who is expanding his hardware store or his plumbing business.

I am told by my Government that I will have to estimate the "life" of my book before I can calculate how to take deductions, once the ordeal of creating it is over. But I do not know how to estimate the "life" of my book. The Authors Guild, of which I am a member and which I have telephoned, doesn't know how to estimate it, either. Even my accountant, who is not a writer (and therefore a very bright chap), says he does not have the slightest idea of what this is all about. He clearly does not understand why I want to be a writer. He tells me that he suspects his little girl, still in school and much interested in books, may also want to be a writer. He is worried about that. She deserves better, he thinks. I agree with him.

As my Senator, I wonder if you would be kind enough to tell me if it is all possible to affect a clarifying change in the Technical Corrections Amendment Bill, so that my fellow writers and I are not subject to the capitalization rules as spelled out in the 1986 Tax "Reform" Act? May I also ask how you feel about the need for a change?

Moreover, since you are a published author of considerable note, I wonder if you might also tell me how to estimate the "life" of my book. Lisa H. is found in some book stores, but not in others. The shelf-life of the average book is now around three months. I have no idea how long my soldiers book will be sold (if, in fact, Simon & Schuster approves of the final manuscripts and pays us the rest of our "advance.")

I might observe here that on occasion, I still consult a very provocative book called Beyond the Melting Pot, which is no longer widely sold in book stores and which, I think, may actually be out of print. It was, after all, created more than two decades ago. Perhaps you can tell me the life of Beyond the Melting Pot, a book with which you have considerable familiarity, and how you might have predicted its life before the fact.

As you have already accurately concluded, I am not terribly adept at making money. I never realized that in order to be treated fairly as an American citizen, I had to be quite so devoted to money. All the writers I know, who work hard and have long ago learned to live low off the hog, accept impecuniosity as the consequence of electing to be a writer. Sometimes public officials do not like us, but it never occurred to me that our Government would want to cause the likes of us to cease to exist.

Despite my disinterest in money and my long history of not making enormous amounts of it, I received a flyer the other day from a publication called the Mutual Fund Forecaster, a periodical that rates mutual funds for those of us who may be interested. Although I do not have a broker, not even a discount broker, and am not about to speculate in the market, the Mutual Fund Forecaster advised me that if I subscribed to it, my subscription "is guaranteed tax deductible as an investment expense under IRS Sections 67 and 212 to the extne that miscellaneous itemized deductions exceed 2%" of my adjusted gross income.

I am not going to subscribe to the Mutual Fund Forecaster, laudable though its objectives and standards may be. For if I did, I would be violating the edicts given me by my Government, which seems to be saying that such deductions are not for the likes of "hobbyists." And in the world of investment, I am afraid that "hobbyist" would be an extremely generous term to apply to me.

What are the chances of changing the tax law so that writers can take deductions, just like other American citizens? How do I estimate the life of my books? Can you take the time to tell me why the Government should be putting pressure on some of its most productive citizens? Can you tell me why the United States should be placing itself in the position of telling writers that it is now illegal to try and to fail? Finally, would you be good enough to tell me who is responsible for the offending language in the Tax Reform Act of 1986 and disclose your assessment of why such an insensitive, ham-handed, unjust law should remain for even another minute on the books of the United States?

Sincerely,

Richard Severo

cc: Sens. Lloyd Bentsen, David Boren, Robert Dole
Reps. Dan Rostenkowski, Thomas Downey, Charles Rangel
Authors Guild

2311 PAULSEN ROAD
ON KISHWAUKEE CREEK
HARVARD, ILLINOIS 60033

Aug 14, 87

Dan Rostenkowski Ch.
Ways + Means Committee

Dear Dan Rostenkowski -

As a member of the Authors' League of America, and the author of two books: Daughters From afar and Profiles of Israeli Women
Israeli Women Speak Out

I urge you to ask a clarification to the 1986 Tax Reform act, in the Technical Corrections Amendment Bill, stating that free lance authors' expenses in researching and writing a book, not be subject to capitalization rules.

Sincerely,

Geraldine Stern

**KANDY STROUD**
3121 "O" STREET NW • WASHINGTON, D.C. 20007

August 21, 1987

The Honorable Dan Rostenkowski
Chairman, Committee on Ways and Means
1102 Longworth House Office Building
Washington, DC 20515

Dear Mr. Chairman:

I am a freelance writer and author. Section 263 A (b) in the 1986 Tax Reform Act threatens my livelihood and the livelihoods of all those like myself who earn their living by the written word. Unlike Gulf Oil or IBM or American Express or other major corporations that make millions in profits and pay few taxes, I earn relatively little, but pay huge taxes. Sometimes I make nothing for an entire year or more while I am researching an article or book. Often I end up spending my entire advance on travel and expenses and have nothing left for groceries or daily living.

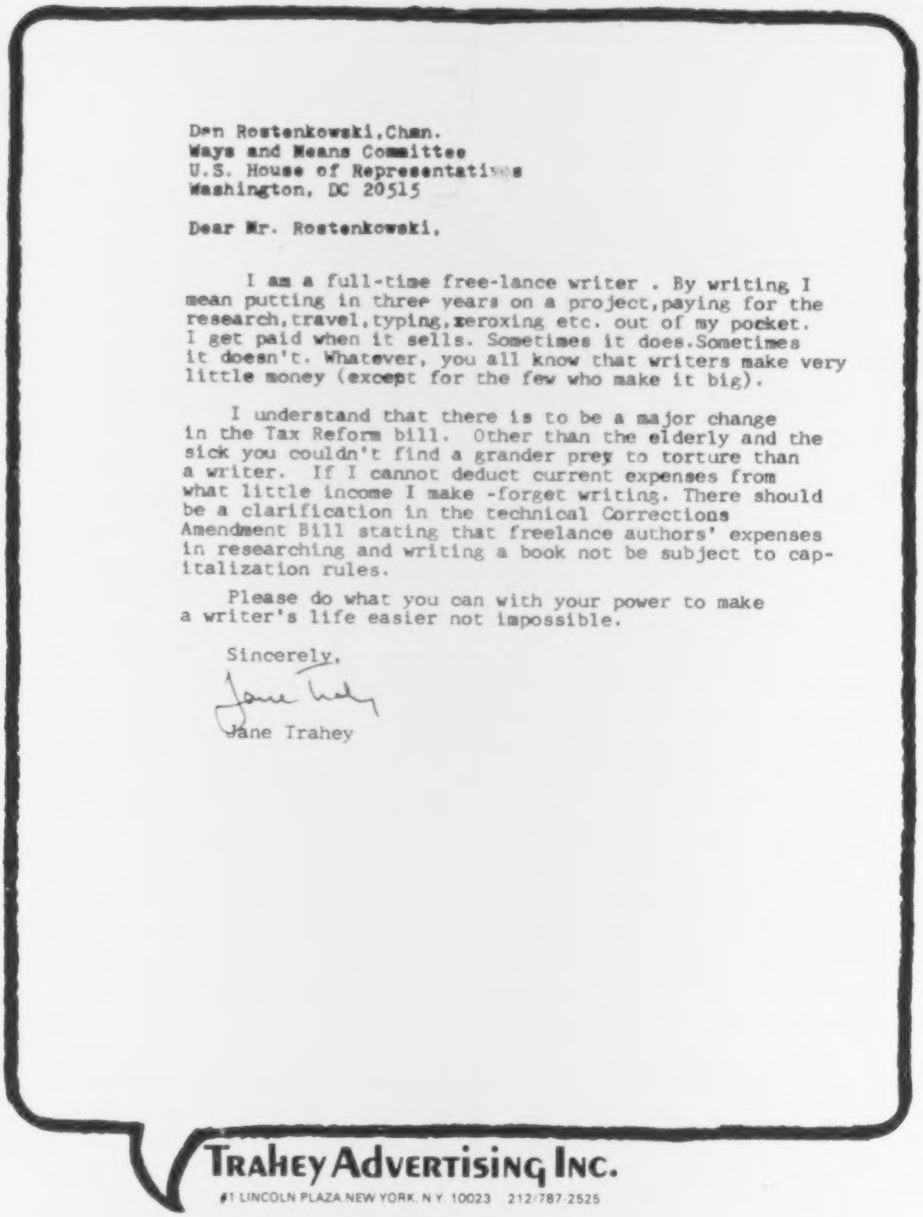
If the provisions of the 1986 Tax Reform Act are implemented, many authors, including myself, will be driven out of the publishing business entirely, especially if we cannot deduct expenses during years when we have no income.

It is an unfair law directed at wordsmiths who earn little, but contribute vastly to the intellectual life of the country. You are in a position to help. Please help.

Sincerely,

Kandy Stroud

Kandy Stroud



Dan Rostenkowski,Chmn.
Ways and Means Committee
U.S. House of Representatives
Washington, DC 20515

Dear Mr. Rostenkowski,

I am a full-time free-lance writer . By writing I mean putting in three years on a project,paying for the research,travel,typing,xeroxing etc. out of my pocket. I get paid when it sells. Sometimes it does.Sometimes it doesn't. Whatever, you all know that writers make very little money (except for the few who make it big).

I understand that there is to be a major change in the Tax Reform bill. Other than the elderly and the sick you couldn't find a grander prey to torture than a writer. If I cannot deduct current expenses from what little income I make -forget writing. There should be a clarification in the technical Corrections Amendment Bill stating that freelance authors' expenses in researching and writing a book not be subject to capitalization rules.

Please do what you can with your power to make a writer's life easier not impossible.

Sincerely,

Jane Trahey

**Trahey Advertising Inc.**
#1 LINCOLN PLAZA NEW YORK, N.Y. 10023 212/787-2525

**Washington Independent Writers**

Legal and Educational Fund, Inc.

205 Colorado Building • 1341 G Street, NW • Washington, DC 20005 • (202) 347-4973

July 20, 1987

Honorable Dan Rostenkowski
Chairman
Committee on Ways and Means
U.S. House of Representatives
Washington, D.C. 20515

Re: Application of Uniform Capitalization Rules
to Independent Writers

Dear Mr. Chairman:

The application of the uniform capitalization rules to independent writers, as appears to be required by Section 263A of the Tax Reform Act of 1986, will work a serious hardship on writers and could discourage many writers from undertaking artistic efforts.

I urge the Committee to correct the devastating effect of application of this rule to writers when the Committee considers the Technical Corrections Amendments to the Tax Reform Act of 1986.

Thank you.

Sincerely yours,

Joseph Foote

Joseph Foote
President

COMMITTEE ON THE BUDGET
CHAIRMAN
TASK FORCE ON COMMUNITY AND NATURAL RESOURCES
COMMITTEE ON FOREIGN AFFAIRS
CHAIRMAN
SUBCOMMITTEE ON AFRICA
INTERNATIONAL ECONOMIC POLICY AND TRADE
CHAIRMAN
NORTHEAST MIDWEST COALITION
WHIP AT LARGE

HOWARD WOLPE
THIRD DISTRICT, MICHIGAN

**Congress of the United States**
**House of Representatives**
**Washington, DC 20515**

1535 Longworth House Office Building
Washington, DC 20515
(202) 225-5011

610 South Burdick Street
Suite 608
Kalamazoo, MI 49007
(616) 385-0039

938 West Columbia Avenue
Suite B
Battle Creek, MI 49015
(616) 961-4576

316 North Capitol Avenue
Suite D1
Lansing, MI 48933
(517) 482-9386

August 24, 1987

The Honorable Dan Rostenkowski
Chairman
Committee on Ways and Means
1102 Longworth HOB
Washington, D.C. 20515

Dear Dan:

Enclosed please find letters from my constituents, Ms. Aletha Lindstrom and Mr. Maris Soule, asking for clarification of the tax treatment of the expenses of freelance writers.

I feel that the expenses of a freelance author should not be subject to capitalization rules, and urge you to consider a clarification of this situation in the Technical Corrections Bill.

Thank you for your attention to this matter.

Sincerely,

HOWARD WOLPE
Member of Congress

---

Aletha J. Lindstrom
12690 [illegible] Road
Battle Creek, Michigan 49017

July 20, 1987

Representative Howard Wolpe
U.S. House of Representatives
Washington D.C. 20515

Dear Mr. Wolpe,

As a freelance writer, my expenses and payments for any articles, etc., that I write and sell are completely different from someone in a business where expenses are predictable.

I believe that there should be some clarification mde in the Corrections Amendment Bill so it will not place an undue burden on Freelance writers.

Thank you for your time and consideration.

Sincerely,

Aletha J. Lindstrom

MARIS A. SOULE
16269 T.S. Avenue E.
Fulton, MI 49052
(616) 746 - 4789

July 14, 1987

Representative Howard Wolpe
U.S. House of Representatives
Washington D.C. 20515

Dear Mr. Wolpe,

I am a freelance writer, have had five books published and have been filing Schedule C (Profit or loss from business or profession, sole proprietorship) since 1983.

As a writer, my expenses are very different from those of someone running a small retail business. Books I am researching now may not be published for years to come, or may never reach the stage where they're accepted for publication. Also, one research trip may ultimately result in several sales.

I need to be able to deduct my expenses as they are incurred, not over the life of a work. For one thing, it would be impossible for me to break down some research as to how much was used for one book and how much for another. And my royalties will be dribbling in for years to come, making calculations on earnings nearly impossible.

Therefore, I would like to request that a clarification be made in the Technical Corrections Amendment Bill, stating that freelance authors' expenses in researching and writing a book not be subject to capitalization rules.

Thank you for your time and help.

Sincerely yours,

Mark Wyman
807 North School • Normal, Illinois 61761
(309) 452-2888

Aug. 12, 1987

Rep. Dan Rostenkowski, Chairman
House Ways and Means Committee
U.S. House of Representatives
Washington, D.C. 20515

Dear Representative Rostenkowski:

As an author of historical works--as well as a citizen of Illinois--may I urge your support for a clarification in the 1986 Tax Reform Act?

Information provided by the Authors Guild has alerted me to the fact that the Act, as now defined, will work a real hardship on people like me who are freelance writers.

Although I am a teacher, my free time is devoted mainly to research and writing. Two of my books have been published: Hard-Rock Epic--Western Miners and the Industrial Revolution, 1860-1910 (University of California Press, 1979), and Immigrants in the Valley--Irish, Germans, and Americans in the Upper Mississippi Country, 1830-1860 (Nelson-Hall, 1984). A third, on the Displaced Persons of Europe after World War II, is tentatively set for publication next year.

I urge you to look again at the 1986 Tax Reform Act with an eye to making a clarification in the Technical Corrections Amendment Bill, to state that the expenses of a freelance author in researching and writing a book not be subject to capitalization rules.

The overwhelming majority of American writers are not--alas!--the well-to-do authors of million-sellers. Most of us scrape by on small earnings. This change will be important in our economic earnings.

Thank you, Representative Rostenkowski, for your attention.

Sincerely,

Mark Wyman

Mark Wyman

MICHAEL ZEILIK
1908 Camino Lumbre
SANTA FE, NEW MEXICO 87505 USA
505-473-1095
18 Aug, 1987

Representative Dan Rostenkowski
U. S. House of Representatives
Washington, D. C. 20515

Dear Representative Rostenkowski:

As a freelance writer, I am writing you in your position as Chair of the House Ways and Means Committee to support a clarification in the Technical Corrections Amendment Bill for the 1986 Tax Reform Act (House Bill 2636). It involves Section 263A, which relates to capitalization rules and the definition of tangible property to which these rules apply. As now in force, these rules would apply to freelance writers, such as myself, and subject me to the same capitalization rules, as, say, a film-making studio. I would be unable to detect current expenses in developing a new project. This would greatly hinder my creative effort, and the money that it generates (which is taxed!). In addition, the rules would be an accounting nightmare to a small (one-person!) business.

I request that a clarification be made to the Technical Corrections Bill so that freelance authors in researching and writing a book will NOT be subject to capitalization rules. Otherwise, you may be a lot of people such as me out of business.

Sincerely,

Michael Zeilik

Michael Zeilik
Astronomy Writer

## Section 803 (Photographers)

## STATEMENT BY HELEN MARCUS, PRESIDENT OF THE AMERICAN SOCIETY OF MAGAZINE PHOTOGRAPHERS ON THE TECHNICAL CORRECTIONS ACT OF 1987 (H.R. 2636 AND S. 1350)

July 31, 1987

Helen Marcus, President of the American Society of Magazine Photographers (ASMP), respectfully submits the following statement concerning the Technical Corrections Act of 1987 for consideration by the U.S. House of Representatives Ways and Means Committee and the U.S. Senate Finance Committee. Founded in 1944, ASMP is the leading voice of the photography industry in the United States and abroad. In addition to the national office located in New York City, there are 29 local chapters throughout the country. Its membership consists of over 5,000 professional photographers. The members work in every area from advertising and industrial/corporate to documentary and photo journalism - in print, tape, and related visual media.

ASMP is an organization of individuals. ASMP Vice President Michel Heron, in a July 13, 1987 article in The Wall Street Journal concerning federal tax law, described a typical professional photographer as "the smallest of the small businesses." Very few professional free-lance photographers haveavailable to them the special legal and accounting tax services which would be necessary to comply with complicated accounting and recordkeeping procedures. With that in mind, it is easy to understand the concern and confusion which ASMP members felt when confronted with the 1985 Internal Revenue Service contemporaneous recordkeeping requirements for their equipment.

It is that same sense of confusion and concern which the ASMP membership felt as it considered the possible consequences of a footnote in the Conference Committee Report in the Tax Reform Act of 1986. The footnote is contained in Title VIII, Section D, page II-308.

The House and Senate conferees had agreed to limit the application of Section 263A uniform capitalization rules to tangible property, thereby excluding intangible property. A footnote was inserted, however, which said that for the purposes of Section 263A, "tangible property includes films, sound recordings, video tapes, books, and other similar property embodying words, ideas, concepts, images, or sounds, by the creators thereof." The footnote was recently referred to in a case decided on May 19, 1987, by the United States Court of Appeals for the Second Circuit, Hadley and Bryant v. Commissioner of Internal Revenue and Garrison v. Commissioner of Internal Revenue, Docket Nos. 86-4148, 4153. In that case, Judge Oakes speculated in dictum that authors of books are now required to follow the uniform capitalization rules. There is great uncertainty among professional photographers as to the effect of the footnote and whether they come within its reach.

ASMP would argue that current expensing of the costs of creating photographs is entirely consistent with the cash method of accounting traditionally permitted for free-lance creators of all kinds. A photographer may shoot thousands of images on a project and perhaps only two or three (or none) will generate any income. When would the appropriate time be to write off a product when it appears it will never sell? Consider also that some images may not generate income for decades, perhaps not even until after the death of the photographer. Since the income stream is difficult, if not impossible, to predict current expensing is the most appropriate method of accounting in the case of photographers.

Furthermore, ASMP believes that the costs which would be required of its members to comply with uniform capitalization rules would be entirely inconsistent with the revenue which can be expected from this provision. The additional costs and lost productivity, with the inevitable reduction in taxable income, would more than offset any expected revenue gains resulting from the capitalization requirements.

Serious ambiguity arises when one considers the previously mentioned footnote. The footnote says that tangible property which must be capitalized includes "films ... and other similar property embodying ... images." Does that refer to the magazine in which the photograph is published, or is it the photograph itself? In Hadley, Judge Oakes ruled that the word "production" in the now-repealed Section 280 was descriptive of what is done by the publisher of the book, not by the author of the manuscript. ASMP would argue it is the producer of the book, the magazine, the advertisement, or any other work embodying the photograph, not the photographer, who was likewise covered by Section 280.

By the same token, the word "produced" in Section 263A is no more descriptive of what a photographer engages in than the word "production" was in Section 280.

Professional photographers pay taxes on their income as they receive it. They are not entities formed for tax shelter purposes. They are individual artists, technicians, and entrepreneurs who contribute to the creative spirit of American society. Just as Congress saw fit to relieve these men and women of the contemporaneous recordkeeping requirements in 1985, it should remove any confusion regarding Section 263A and expressly exclude photographs, images and similar property from the definition of tangible property. One way to achieve that result and remain consistent with other provisions of the Internal Revenue Code would be to exempt from Section 263A(b) property defined in Section 1221(3). Capitalization rules apply to capital assets, items with a useful life beyond the year in which they are produced. Section 1221(3) expressly states that the term "capital asset":

> "does not include a copyright, a literary, musical or artistic composition, a letter or memorandum, or similar property, held by - (A) a taxpayer whose personal efforts created such property, (B) in the case of a letter, memorandum, or similar property, a taxpayer for whom such property was prepared or produced, or (C) a taxpayer in whose hands the basis of such property is determined, for purposes of determining gain from a sale or exchange, in whole or part by reference to the basis of such property in the hands of a taxpayer described in subparagraph (A) or (B)."

ASMP respectfully suggests that an amendment to the Technical Corrections Act of 1987 which would exempt property defined in Section 1221(3) from coverage under Section 263A would clarify the confusion surrounding this issue. It would provide a consistency between Sections 1221(3) and 263A. Such an amendment would also further Congress' tax reform goals of simplifying the tax code and improving taxpayer compliance.

For all of the foregoing reasons, ASMP urges adoption of the corrections described above. ASMP appreciates this opportunity to convey its views regarding Section 263A, and to submit its testimony at this time.

**KENN BROCK**
PHOTOGRAPHER

August 29, 1987

The Honorable Dan Rostenkowski, Chairman
Ways and Means Committee
U.S. House of Representatives
Washington, D.C. 20515

Dear Representative Rostenkowski,

Today I learned how the new Tax Reform Act of 1986 severely impacts my small business as a photographer. You may have supported this legislation without knowing the consequences to a free-lance photographer.

The new uniform capitalization rules make it virtually impossible for me to write off my business expenses for the production of photographs in the same year the work is created unless that work is sold and all future rights in that same year.

Free-lance creators have always taken expenses in the year in which they are incurred. But under the new uniform capitalization rules, this would no longer be possible. Now, free-lance creators can recover expenses only through depreciation and amortization. This requires photographers to forecast the income stream for each photograph created, a virtually impossible task for a professional photographer, who typically creates thousands of images each and every year.

The uniform capitalization rules make my business unworkable. This runs contrary to the tax reform goals of simplification and improved taxpayer compliance. It also runs contrary to the capitalization rules found in Section 1221(3) which exempt a copyright (photographs hold copyrights) from being a "capital asset" and thus allowing expenses to be deducted in the year of occurrence.

Please support an amendment to the Technical Corrections Act (H.R. 2636 and S. 1350) to exempt professional photographers from these uniform capitalization rules for the production of still images.

Thank you for your consideration.

Sincerely,

Kenn Brock

(214) 328-4794 P.O. BOX 10106 DALLAS, TEXAS 75207

[redacted]

CRAWFORD
PHOTOGRAPHER

The Honorable Dan Rostenkowski
U. S. House of Representatives
Washington, DC 20510

Dear Representative Rostenkowski:

I just found out today about a section in the Tax Reform Act of 1986 that may soon put me out of business. I have been a free-lance photographer for many years and in my small business I create thousands of images EACH YEAR. Some of them are sold immediately to clients who commissioned the photography, but many more remain as "out-takes", or "extras" which are then available for use as "stock photography".

Under the UNIFORM CAPITALIZATION RULES I will NO LONGER be able to write off my business expenses for that production in the SAME YEAR unless ALL the images were sold.

Individual movie makers do not each create thousands of films every year, individual authors do not each write thousands of books every year.....but STILL PHOTOGRAPHERS ARE DIFFERENT in that we EACH create THOUSANDS of UNIQUE images EVERY YEAR.

The uniform capitalization rules make my business unworkable. This runs contrary to the tax reform goals of simplification and improved taxpayer compliance.

Please support an amemdment to the TECHNICAL CORRECTIONS ACT(H.R. 263A AND S. 1350) to exempt professional photographers form these UNIFORM CAPITALIZATION RULES FOR THE PRODUCTION OF STILL IMAGES.

Thank you for your sincere concideration.

Sincerely,

Clint Crawford

[redacted]

Dale
GEFFS

August 20, 1987

The Honorable Dan Rostenkowski
House of Representatives
Washington, DC 20515

Dear Representative Rostenkowski:

The Tax Reform Act of 1986 is going to severely impact my small business as a photographer. Specifically the new uniform capitalization rules, as applied to photographic images, will have a chilling effect on photographers and may even force some of us out of business. You may have supported this legislation without knowing the consequences to a free-lance photographer.

Most people agree that tax reform is necessary. Even though I don't like many of the changes imposed on small business, most of the changes are workable and can be dealt with. The new uniform capitalization rules, on the other hand, make it virtually impossible for me to write off business expenses for the production of photographs in the same year the work is created unless that work is sold in that same year.

The useful life of a photograph is infinite. The paperwork and guesswork involved in capitalizing photographic images is mind boggling. The uniform capitalization rules make my business unworkable. This runs contrary to the tax reform goals of simplification and improved taxpayer compliance.

I am sure the intent of all tax reform is to eliminate loopholes and make sure all taxpayers pay their fair share. However, this Act is placing an undue burden on those of us who are legitimate professional photographers. **We must be able to deduct business expenses in the year they occur!**

**Please support an amendment to the Technical Corrections Act (H.R. 2636 and S. 1350) to exempt professional photographers from these uniform capitalization rules for the production of still images.**

Thank you for your consideration.

Sincerely,

Dale Geffs

Dale Geffs, Photographer
15715 Amapola, Houston, Texas 77083
(713) 933-3876

August 24, 1987

**Douglas Johns**
PHOTOGRAPHIC DESIGN

2535 - 25th Avenue North
St. Petersburg, FL 33713
(813) 321-7235

The Honorable Dan Rostenkowski
Chairman Ways and Means Committee
U.S. House of Representatives
Washington, D.C. 20510

Dear Representative Rostenkowski:

Today I learned how the new Tax Reform Act of 1986 severly impacts my small business as a photographer. You may have supported this legislation without knowing the consequences to an independently employed photographer.

The new uniform capitalization rules make it virtually impossible for me to write off my business expenses for the production of photographs in the same year the work is created unless that work is sold in that same year.

Freelance creators have always taken expenses in the year in which they are incurred. But under the new uniform capitalization rules, this would no longer be possible. Now, freelance creators can recover expenses only through depreciation and amortization. This requires photographers to forecast the income stream for each photograph created, a virtually impossible task for a professional photographer, who typically creates tens of thousands of images each year.

The uniform capitalization rules make my business unworkable (and extremely unprofitable). This runs contrary to the tax reform goals of simplification and improved taxpayer compliance.

**Please support an amendment to the Technical Corrections Act (H.R. 2626 and S. 1350) to exempt professional photographers from these uniform capitalization rules for the production of still images.**

Thank you for your consideration.

Sincerely,

Douglas Johns

[redacted]

DAN ROSTENKOWSKI
CHAIR OF WAYS & MEANS
HOUSE OF REPRESENTATIVES
WASHINGTON, DC 20510

August 26, 1987.

Dear Mr. Rostenkowski:

I have just been informed that the new Tax Reform Act of 1986 will severely and negatively influence my ability to do business as a photographer. You may have supported this legislation without considering the burden that this would place upon a free-lance photographer.

The new uniform capitalization rules make it virtually impossible for me to write off my business expenses for the production of photographs in the same year the work is created unless that work is sold that same year.

Free-lance creators have always taken expenses in the year in which they are incurred. But under the new uniform capitalization rules, this would no longer be possible. Now, free-lance creators can recover expenses only through depreciation and amortization. This requires photographers to forecast the income stream for each photograph created a virtually impossible task for a professional photographer, who typically creates tens of thousands of images each year.

The uniform capitalization rules would make it totally unprofitable for me to remain in business because of the time ( money ) and personnel required merely to keep these records.

Also, the tax burden will become a disproportionately large portion of the relatively small value of any given photograph that the incentive will be NOT TO produce photographs. In the light of production incentives offered to our oriental neighbours and even to our " glasnost " competitors by their respective governments, I question the wisdom of this tax provision. Finally, this runs contrary to the goal of providing incentive for taxpayer compliance.

Please support an amendment to the Technical Correction Act ( H.R. 2636 and S. 1350 ) to exempt professional photographers from these uniform capitalization rules for the production of still images.

Thank you for your consideration.

Sincerely,

Bob Kiss

KISS PHOTOGRAPHY INC. 29 EAST 19 STREET, NEW YORK, N.Y. 10003 (212) 505-6650

STEVE
LEONARD
PHOTOGRAPHY

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August 21, 1987

The Honorable Dan Rostenkowski
U.S. House of Representatives
Washington, DC 20510

Dear Representative Rostenkowski:

Today I learned how the new Tax Reform Act of 1986 severely impacts my small business as a photographer. You may have supported this legislation without knowing the consequences to a free-lance photographer.

The new uniform capitalization rules make ti virtually impossible for me to write off my business expenses for the production of photographs in the same year the work is created unless that work is sold in that same year.

Free-lance creators have always taken expenses in the year in which they are incurred. But under the new uniform capitalization rules, this would no longer be possible. Now, free-lance creators can recover expenses only through depreciation and amortization. This required photographers to forecast the income stream for each photograph created, a virtually impossible task for a professional photographer, who typically creates tens of thousands of images each year.

The uniform capitalization rules make my business unworkable. This runs contrary to the tax reform goals of simplification and improved taxpayer compliance.

Please support an amendment to the Technical Corrections Act ( H.R. 2636 and S. 1350) to exempt professional photographers from these uniform capitalization rules for the production of still images.

Thank you for your consideration.

Sincerely,

Steve Leonard

ND DAVID NANCE, PHOTOGRAPHER
8202 FERNBROOK LANE • HOUSTON, TEXAS 77070 • (713) 469-4757

August 26, 1987

The Honorable Dan Rostenkowski
Chairman Ways and Means Committee
The U. S. House of Representatives
Washington, D.C. 20510

Dear Representative Rostenkowski:

Today I learned of a new assault on my small business, the Tax Reform Act of 1986. You may have supported this legislation without knowing the consequences to a free-lance photographer.

The new uniform capitalization rules make it virtually impossible for me to write off my business expenses for the production of photographs in the same year the work is created unless that work is sold in that same year.

Free-lance creators have always taken expenses in the year in which they are incurred. Under the new uniform capitalization rules, this would no longer be possible. Now, free-lance creators can recover expenses only through depreciation and amortization. This requires photographers to forecast the income stream for each photograph created, a virtually impossible task for a professional photographer, who typically creates tens of thousands of images each year.

The uniform capitalization rules make my business unworkable. This runs contrary to the tax reform goals of simplification and improved taxpayer compliance. If the Texas economy doesn't finish my business first, these new rules will.

Please support an amendment to the Technical Corrections Act (H.R. 2636 and S. 1350) to exempt professional photographers from these uniform capitalization rules for the production of still images.

Thank you for your consideration.

Sincerely,

David Nance

David Nance

**James H. Pickerell**
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Rockville, Maryland 20850
301-251-0720

## COMMENTS DIRECTED TO COMMITTEE ON WAYS AND MEANS, U.S. HOUSE OF REPRESENTATIVES AND RELATING TO H.R. 2636, THE TECHNICAL CORRECTION ACT OF 1987

My comments are directed toward Code Section 263A on capitalization and inclusion in inventory costs of certain expenses.

I understand the purpose of this rule is to provide one uniform standard for capitalization of cost of all property not sold and consumed in the year in which it is produced.

On its face, this would appear to simplify the law. However, all businesses are not the same. Congress discovered, even as they were writing this section, that there were certain types of business that they had to exempt from this uniform standard because they could not capitalize their property in the manner outlined in 263A and continue to survive.

These include the farming business, the business of raising timber and ornamental trees and certain development cost for oil and gas wells and other mineral property.

I believe the "stock photography" industry will also be destroyed by this regulation and I would like to explain why.

This is a small industry, probably employing fewer than 20,000 in the United States and some of these people are part time (no accurate figures are available). The estimated gross revenue from this industry is around $400 million worldwide.

There are two basic aspects to the industry--the individual photoraphers who create the work, and the stock photo agencies who act as marketing representatives for these photographers. It is these two groups that will be most severely impacted by this Law. These photographers and agencies are also clients of other support industries such as photo labs, film manufacturers, equipment manufacturers and photo supply houses who will be impacted by whatever happens to the "stock photo" industry.

It is not widely understood what we do, thus I believe I need to explain a little of how the business works.

### METHODS OF OPERATION OF PHOTOGRAPHERS WHO PRODUCE "STOCK PHOTOGRAPHS" FOR PUBLICATION

As best I can determine the business started back in the 1940's when the major picture magazines had to have photographers cover every news event in order to be sure they had photographs of the major news when it happened. At the end of each week they had an extremely high percentage of pictures they were paying for, but couldn't use because the event never developed into a major news story.

To keep their costs at a manageable level, they paid the photographer very little per day for their time. Most photographers, with exception of a few stars, found they could not afford to live on these rates.

The magazine didn't want to pay more, but they decided they could allow the photographer to use the pictures in other ways after the magazine had finished with its initial use. They also decided that if for some reason they used the pictures a second time they could afford to pay an additional fee.

On these two principles the "stock" photo industry was born. "Stock photography" is basically photography that has been produced, and is held available in file, until a user indicates that he would like to license a certain use of that picture.

Most pictures have the potential of being licensed many times for non-competitive uses.

Originally, "stock photography" only resulted after pictures were first taken as part of a specific assignment by someone. However, in recent years, and particularly after the 1978 Copyright Law redefined ownership, more and more photographers have been taking pictures at their own expense of those subjects which they feel will be in demand in the future, and placing them in "stock photo" files.

The photographer assumes a giant risk here because he has to cover all the expenses of production, up front and this can run as high as several thousand dollars for some shoots. If he is going to invest this kind of money he has to have a clear understanding of the market potential for the images he is going to produce, and he has to be confident in his ability to produce the quality of images that the clients will eventually want to use and purchase.

Everyone in this business also has to deal with another great unknown. That is whether or not some competitor will produce a new set of pictures on the same subject that when compared with those produced first will make them obsolete. The client will always pick that "stock photo" that best fits his particular need. There is no loyalty by the clients to particular photographers. The business is all based on the quality of the photograph.

For this reason "stock photographers" must constantly try to improve on things they have already produced.

While this business has some obvious inefficiencies due to its competitiveness it results in better quality photographs, available to the clients, when they need them, at a price that is usually much less than what the client would have to pay for original photography.

It also makes full use of a good photograph once it is produced, rather than having to go back and do the same thing over and over again.

## IMPACT ON PHOTOGRAPHERS WHO TAKE STILL PICTURES:

Traditionally, still photographers have written off all costs of production in the tax year they were incurred. Traditionally, still photographers have not "sold" all rights to their work, but "licensed" usage rights.

This tax law will:

(1) Bring about a total reversal in these methods of operation.

(2) Force many photographers out of business, particularly young photographers who have little capital reserve, and who fail to restructure their metods of pricing properly.

(3) Cause those who survive to totally change their methods of doing business to avoid holding pictures in inventory, and thus avoid coming under the capitalization rule.

(4) Decrease productivity by making it uneconomic to produce "stock photography" during slow periods for assignments, or requiring tremendous amounts of paperwork for those who want to attempt to continue to shoot for the "stock photo" market.

(5) Force photographers to destroy much of the future historical record of this country in order to keep from holding it in inventory.

(6) Make it much more difficut for young people to enter the profession.

(7) Result in a greatly elevated cost of photographs for textbooks because such pictures will not be available in the stock photo market, and will have to be produced in the future as original photography. This increased production cost will undoubtedly be passed along to the textbook consumer, thus increasing the cost of education.

While doing all these negative things to the photographic industry, I predict that 263A, as written, will not raise much revenue from photographers. The additional tax that will be required as a result of this law will be so staggering, and the paperwork so impossible to maintain, that virtually all photographers will simply drop out of the "stock photo" business. They will be forced by economic realities to take only those jobs where they are paid a specific fee for doing specific work and where they turn over all rights to the client at the time of creation.

## IS THERE A SOLUTION TO THIS PROBLEM IN 263A?

Congress recognized that the small retailer would have a fatal cash flow problems if he were required to capitalize all his overhead expenses. Thus, Congress provided relief for this industry with the exception in 263A(b)(1)(B).

The small independent creator of work has a similar cash flow problem and I believe that Congress meant to include these individual creators of property in the same execption. I would ask that the same or similar language to the above exception be placed under 263A(b)(1) as a matter of clarification.

## PERSONAL BACKGROUND

I would like to provide you with a little personal background to establish my credentials for making this request, and explain in detail how this law will affect me.

I have been a photographer producing works for publication for over 25 years. My pictures have been published in more than 500 publictions around the world including a Life cover, and eleven covers on Newsweek. I have worked in more than eighty countries around the world on corporate and editorial assignments. I spent three and a half years covering the war in Vietnam as a freelance photo journalists and was the first American correspondent wounded in that war.

I have been active in the field of "stock photography", particularly in the past ten years. I am a recognized expert in this area of the business, and have been a speaker at many seminars on this subject.

## HOW THIS LAW AFFECTS ME

Nearly all the photographs I take are used in one way or another for publication. I take pictures on specific assignment from various clients. Sometimes my arrangement with these clients is that I deliver the photos they need for their use, and I retain the "seconds" for the purpose of licensing usage rights to various other clients.

In such cases the fee the original client pays would more than cover all the "direct costs" of the project. I suspect this fee also covers all the "indirect costs" of doing the job, but I have never calculated indirect expenses on a job by job basis in that way so I can not be sure that I am not losing on some jobs and making up for them on others. I do know that I show a profit at the end of each year.

I also spend a lot of my time taking pictures specifically for the "stock photography" market. There is no guarantee that I will ever be able to license usage rights to any of these photos. As a matter of fact, more than 90% of the images I take for this market are never used.

While I cannot predict which specific images will sell and which will not, I have learned that the percentage I sell in relation to the number I have on file remains fairly constant. Therefore, the more I create and put in file, the more income I make.

I have also developed an ability, after years of experience, to choose wisely the subjects I photograph. Thus, some images from every situation I photograph will eventually sell. This would not necessarily be the case for someone learning the business because it takes time to get a thorough understanding of the market.

In the first six months of 1987 I had gross receipts from all areas of my business of $95,904.53. This breaks down into the following categories:

| | |
|---|---|
| Income from photos in my files and those held for me by stock picture agencies. All were produced before 1987 and expensed at the time of production | $49,254.45 |
| Gross income and reimbursed expenses from assignments where I sold all rights and where there will be no further use of the pictures beyond 1987 | 12,946.04 |
| Income from other services, (lab work, computer lists, consulting, etc, which can be expensed in 1987. | 4,109.51 |
| Income from assignments where I retain some rights to use some of the pictures | 29,594.53 |

In this six months, I spent 11.2 days taking pictures to which I sold all rights, and 34 days taking pictures where I retained some or all of the rights to the pictures.

Most people would say, "Hey, he only worked 45 days in the last six months. That's a great job. I want to get into that business." Actually, I average over 60 hours a week at my work. The rest of time over and above the 45 days spent taking pictures was spent in various administrative tasks necessary to running my business, but which do not directly contribute to income.

These include: marketing (getting new assignment business and preparing the stock photos for market), repair & maintenance, training and testing new concepts for photos, researching locations, bookkeeping and tax accounting. I view all of this time as necessary, but non-productive because no income is being produced during this time.

A fairly large portion of this time is spent keeping records for the sole purpose of being able to correctly compute my tax liability. Most of these records are of little or no other value in managing my business. I recognize the need for each individual taxpayer to be able to properly compute the tax he owes the government, but the more complex this gets, the less time the taxpayer has to do work that will produce the income on which this tax is computed.

The 1986 tax law certainly did not reduce the record keeping that will be required of photographers in order to compute their tax obligation.

As I look at the photography I have produced in the past six months, three quarters of my production time has been spent on jobs where I retained some of the rights.

This may mean that three quarters of all the expenses I had in my business in the first six months must be depreciated over the useful life of the photographs.

However, there are several questions that are not clearly answered in Section 263A or in the Income Tax Regulations (26 CFR Part 1):

1 - How do I make a realistic estimate of useful life of these photographs?

Over 90% of the images I produce for stock will never sell. I just don't know which 90%. It depends on future demand, future production of my competitors, and individual judgements by the buyers. Twenty five years in this business has taught me that there is no way for me to make judgements on future value of these photographs?

With the exception of a few very unique photographs that have been determined to be great art like the work of Ansel Adams, there is no ready market for the millions of photographs that are produced each year.

2 - Can I deduct all the expenses for advertising and marketing that is directed toward getting jobs where I would sell all rights?

3 - Can I deduct as expenses the costs of preparation of the already created stock photo for market? This is a very costly part of the process, without which the photographs would never have a chance of selling. Is this a part of the creation of the product, or is it a selling expense that can be deducted?

5 - How should I deal with pictures that are taken toward the end of one fiscal year, but are not used or paid for until the next fiscal year even though the general understanding at the time the picture was taken was that the client was purchasing all rights to the photograph?

6 - What about the situation where I take pictures for a client and sell all ownership rights to those pictures, but I retain the negatives on file as a convenience and service to the client in case he might want additional prints sometime in the future? Whose inventory are they in?

Let's look at how this would affect my tax picture. Assume that I can do as well in the second half of the year as I have done in the first. Then my total gross receipts would be $191,809 and my total gross expenses would be $84,692.

In the first half of the year I have sold all rights on about 25% of the projects I have worked on, and retained ownership in some, if not all the photographs, produced on the rest of the projects.

If I calculate my 1987 tax based on these figures and depreciate 75% of my expenses over a five year average useful life my tax will be more than 50% higher that it would have been were I allowed to continue to operate under the 1986 law.

I didn't expect to have no tax increase as President Reagan promised, but I didn't anticipate a 50% increase either.

## STRATEGY FOR SOLVING THE PROBLEM

Obviously, such a tax increase will have serious impact on my business.

The first thing I will do is start selling all rights to the photographs I produce, and stop shooting for the "stock photo" market. Then all the expenses of production will be deductable in the year expensed as they have been in the past.

That presents a few problems because one of the reasons I got into the "stock photo" market in the first place was that it was a way to increase my productivity when I couldn't get enough assignment work to keep myself busy and make a decent living.

At this point in my career, I may be in a better position to get assignment work than I was before. The same will not hold true for the young people who have just entered the profession in the last few years.

I may continue to put a few selected photos a year into the stock photo market and depreciate the direct costs and the overhead costs for these photos.

However, I will not be able to supply them to the stock photo agencies consistantly throughout the year. It will be necessary to wait until December of each year before I can determine actual costs of each set of photographs and which ones, if any, that I have produced during the year are the best candidates for the stock photo market.

I know what the direct costs of these photos are, but it will be the indirect costs which will be the more severe strain, and I have no realistic way of even estimating that cost until near the end of the year when I have some idea of the kind of assignments I have had over the year, the quality of the images produced and which ones have the best potential for the stock market. Those of lesser quality will have to be destroyed. If I do that then I will have received 100% of the income from these images in the year they were produced and thus, I can deduct 100% of the expenses.

For many businesses this would not be a problem or a consideration. They would simply go out and borrow the money to pay the additional tax recognizing that down the road the money would be coming back as they get additional depreciation in future years.

Most photographers don't have that option. We are not producing a product that has a recognized market value. The product only has value when potential user agrees to pay a fee to use the image. No banker will loan a dime on this kind of collateral. For most photographers the only access to capital is profit from previous jobs.

The younger, less experienced photographers--those on their way up--will not have the same options I have. If they are to build a file that will produce income in future years they will have to invest a much higher percentage of their capital than I do in producing pictures for the files. However it is unlikely that they will have the capital available to do this. Because of this, I predict that the business of "stock photography" will atrophy and die as a result of this law.

This law will also cause much of our future art heritage and historical record to be destroyed because no one will be able to afford to hold it in inventory.

To amplify this point, let me detail one specific example that occurred with my work.

Early in my career as a photographer I spent three-and-a-half years covering the war in Vietnam.

During this period my work was used in most of the major news magazines of the world and I retained ownership to the majority of the photographs I produced. The expenses I incurred were totally written off against my tax obligation in the year in which they were incurred.

But let us assume for the moment that 263A had been the law and the somehow I could have afforded to depreciate these photos over their useful life. As it turned out within a year or two after I had taken these pictures there was little demand for them.

Users at first wanted the new, more dramatic photos that were being produced every day. Then there came a time when the U.S. left the war and you couldn't give a Vietnam photograph away. Nobody wanted to talk or hear about Vietnam.

If I had been operating under the present tax law at that time, I would have had a difficult decision to make as a businessman. Do I destroy this work, thus removing it from inventory so I can take the total write off and use the money to get on with creating other income producing product, or do I retain it for its historical value at great personal cost to me?

As it turned out ten years after the war and more than fifteen years after I had produced most of my photographs there was a revival of interest in analyzing the war. There was a demand for my photographs for books being produced as a historical record. They were also used in museum exhibits to help raise the consciousness of those who would view these exhibits.

I made a significant amount of income off of those pictures at that point on which I paid tax.

Under the rules of this bill undoubtedly those pictures would have been destroyed because it didn't make good economic sense to retain them.

Another area where I license the use of a lot of stock photos is the textbook market. Textbooks are one of the largest users of "stock photography". In my judgement, this law will have a serious impact on this market.

I would estimate that over 90% of the photographs presently used in textbooks are stock photographs. Almost all of these photos were originally shot for some other purpose. The textbook producers make very few assignments because they can not afford fees that are even close to normal assignment rates for the pictures they need.

If "stock photographs" are no longer available to them, they will have to make assignments and I'm sure the additional costs of production will result in more expensive textbooks. This will bring in tax revenue, but from an unexpected source. I would ask you to consider whether it is in the best interest of the country to increase the cost of education.

END END END END END

**Ben Smusz Photography**
**Bel-Air Photo Co.** (713) 666-1511

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August 21, 1987

The Honorable Dan Rostenkowski
U.S. House of Representatives
Washington,DC 20510

Dear Representative Dan Rostenkowski:

Recently I learned how section 263A of the new Tax Reform Act of 1986 severely impacts my small business as a photographer. You may have supported this legislation without knowing the consequences to free-lance photographers and authors.

Free-lance creators have always taken expenses in the year in which they are incurred. But under the new uniform capitalization rules, this would no longer be possible. Now, free-lance creators can recover expenses only through deprecation and amortization. This requires photographers to forecast the possible income stream for each photograph created, a virtually impossible task for a professional photographer, who typically creates thousands of images each year. But, even if there were only 50 images each year on which to forecast sales, it would still be virtually impossible to obtain anywhere near an average sale price.

The new uniform capitalization rules make it virtually impossible for me to write off my business expenses for the production of photographers in the same year the work is created unless that work is sold in that same year.

The uniform capitalization rules make my business unworkable. This runs contrary to the tax reform goals of simplification and improved taxpayer compliance.

Please support an amendment to the Technical Corrections Act (H.R. 2636 and S. 1350) to exempt professional photographers and authors from these uniform capitalization rules for the production of still images.

Thank you for your consideration.

Sincerely,

Ben J. Smusz

2511 W. Holcombe Blvd. Houston, Texas 77030

## Section 804

### Comments on Technical Corrections to the Tax Reform Act of 1986

The Associated General Contractors of America is a construction trade association representing more than 32,500 firms, including 8,400 of America's leading general contracting construction firms. These contractors perform more than 80 percent of America's contract construction of commercial buildings, highways, industrial, and municipal-utility facilities, and employ more than 3,400,000 individuals. AGC appreciates the opportunity to provide comments prior to the Committee's consideration of the Technical Corrections Act of 1987, H.R. 2636.

### New Accounting Methods for Long-term Contracts Are Extremely Difficult for Construction Firms to Administer

The Tax Reform Act of 1986 requires firms with more than $10 million in annual gross receipts to use one of two new accounting methods for long-term contracts entered into after February 28, 1986. One method, the percentage of completion method, recognizes income for tax purposes according to the percentage of the contract completed during the taxable year. The progress toward completion of the contract must be calculated by comparing the costs incurred on the project during the taxable year to the total estimated costs for the contract.

The second allowable method is the percentage of completion-capitalized cost method (40-60 method). Under this method 40 percent of the contract items are accounted for using the percentage of completion method and 60 percent of the items are accounted for under the taxpayer's normal method, often the completed contract method of accounting.

The percentage of completion method and the 40-60 method both contain a provision called the "look-back" method to correct for estimation errors. Due to the inherent difficulties in forecasting the profit or loss on a contract, the Tax Reform Act of 1986 provides a way for contractors to "look-back" after the completion of a contract when actual costs and contract price are known.

The contractor recalculates all of the computations relating to each contract based on actual figures and recomputes the tax owed in each year of the contract. Interest would then be paid to the contractor by the Treasury if overpayments were made during the life of the contract, or the taxpayer would pay interest to the Treasury if underpayments had been made in years prior to contract completion.

While the goal of the look-back method is admirable, many serious problems remain in applying the method in the construction industry. The problems, which at times seem insurmountable, include integrating the look-back rule with the new alternative minimum tax and the correct treatment of contract disputes and lawsuits.

Many construction industry taxpayers have a large number of contracts; one AGC large regional construction firm had 770 contracts last year, another contractor had 450, and a third construction firm had 360 contracts. These firms are representative of large AGC members, but they are not the largest.

Congress did exempt small construction contractors with less than $10 million in average annual gross receipts from the new accounting methods, retaining prior law for these firms. While AGC is most appreciative and supportive of this carve-out, this exclusion did not lessen the administrative burden on many firms with gross revenues above the $10 million cut-off.

To illustrate, AGC asked a small contractor with $10.3 million in volume last year to provide a profile of the firm. This contractor had 25 contracts in process during the year ranging in value from $25 thousand to $3.9 million with contract durations of from one to eighteen months. During the year the company employed 120 people consisting of a general manager, two clerks, two estimators, and 115 field personnel.

The accounting, except for writing payroll checks and preparing billings, was done by an outside firm as was the auditing and preparation of tax returns. Another $12 million building contractor is known to have 150 contracts, 50 of which may be open at the end of a year, without any additional accounting staff.

The tax accounting changes brought about by the new law on long-term contracts are both complex and difficult to administer. AGC construction contractors are very concerned about the added paperwork and administrative costs which are a direct result of the new law. The construction industry does not believe that either added costs or paperwork of this magnitude is in the best interest of the industry or national policy. These added costs are non-productive and make the industry less competitive.

An important consideration is that the industry does not believe that the revenue gained by the Treasury, if any, from the lookback provision as it now stands is a sufficient reason for burdening the industry with tremendous added costs and paperwork.

AGC supports the provision included in H.R. 2636 which authorizes the Secretary of the Treasury to simplify the allocation of costs to a contract for purposes of applying the percentage of completion method. However, serious paperwork and administrative problems have not yet been addressed. Therefore, the industry is proposing that Congress consider several additional technical corrections to minimize the burden without jeopardizing the intent of Congress with regard to the accounting methods.

## Proposed Technical Correction to Provide a De Minimus Rule for the Lookback Method

AGC recommends that a de minimus rule be made available to contractors to reduce the administrative burden of the look-back method contained in section 460 (a) and (b). The proposed rule would exempt contracts from the look-back method if the 1) contract price is less than $1,000,000, 2) the contract is completed within two years, and 3) the contract price is less than 1 percent of the taxpayer's average gross receipts for the prior three years.

The sole purpose of this proposed provision is to minimize the administrative burden of the lookback method. The provision should not have a revenue impact on the Treasury, as the lookback method can work to either the taxpayer's benefit or the Treasury's depending on the direction of the estimation error.

As an additional safeguard for the Treasury, AGC calculated that for the contractors using this rule almost all of their contract revenue would be retained under the look-back method. Data provided to the Joint Committee on Taxation by four large AGC members showed that the proposed rule would retain subject to the look-back method 96 percent, 93 percent, 99.7 percent, and 95 percent of their contract revenue, respectively. The value of the rule is that while most of the contract revenue was retained, the rule would minimize the lookback paperwork by excluding 78 percent, 77 percent, 9 percent, and 94 percent of their contracts, respectively.

AGC strongly urges the Committee to adopt this provision during consideration of the Technical Corrections measure to reduce the administrative burden of the accounting changes without impacting the intent of the new law.

## Proposed Technical Correction to Allow Small Contractors to Use Financial Statement Percentage of Completion to Calculate the AMT Percentage of Completion Preference

The new corporate alternative minimum tax (AMT) requires the taxable income of a taxpayer engaged in long-term contracts to be computed using the new percentage of completion method as modified by Section 460 (b). However, during the mark-up of the Tax Reform Act of 1986 in the Ways and Means Committee the Committee recognized that many small construction contractors do not have sufficient resources to comply with the new long-term contract accounting methods.

The Committee therefore adopted an exclusion from the new long-term contract accounting methods for contractors with less than $10 million in average annual gross receipts. These contractors are allowed to continue using their normal method of accounting as under prior law.

These contractors with receipts of less than $10 million would therefore have no reason to compute the new, complicated percentage of completion method except for the requirement that all contractors compute it as the basis for the AMT calculation. AGC believes that this is clearly contradictory, and urges the Congress to adopt another acceptable method of computation of the AMT calculation for contractors qualifying for the small contractor exclusion.

One proposal would allow contractors who construct or improve real property and have less than $10 million in average annual gross receipts to use the percentage of completion method that they compute for their financial statements according to generally accepted accounting principles as the basis for the AMT computation. Many small contractors would have this available as the financial statements are generally required by bonding companies or banks in the normal course of business.

This proposal would relieve a tremendous paperwork burden being imposed on small contractors under the new law, with no identifiable revenue impact. The financial statement percentage of completion is unlikely to differ appreciably, except in computational difficulty, from the computation required by the Tax Reform Act of 1986 for these contractors.

Almost all contractors who qualify for the small contractor exception do not have in-house accounting assistance, as described above. Therefore, the new, more complicated tax method of percentage of completion would have to be computed by an outside accounting firm, at a substantial additional cost to the taxpayer. AGC strongly urges the Committee to adopt this provision during the Committee's consideration of the Technical Corrections bill.

## Treatment of Recoveries from Contract Disputes and Lawsuits under the Lookback Method

During Congressional consideration of the Tax Reform Act of 1986 the appropriate treatment of recoveries and awards received by a contractor as a result of a contract dispute, arbitration, or lawsuit was never explicitly considered. The construction industry believed that current practice would be followed, and that recoveries received as a result of the pursuit of a claim or lawsuit following contract completion would be treated as a separate event under the percentage of completion method. This would be entirely consistent with the tax policy as applied to other accrual method taxpayers.

On May 4, 1987 the Joint Committee on Taxation released the General Explanation of the Tar Reform Act of 1986, termed the "Blue Book". The Blue Book stated for the first time that for purposes of the look-back method as it applies to the new percentage of completion method, the contract price shall reflect all amounts received under the contract, including amounts received after the contract completion date as a result of disputes, litigation, or settlements relating to the contract.

This statement has significant consequences for the construction industry. Lawsuits and disputes between construction contractors and owners arise all too frequently. The usual situation is one in which a contractor finds his company in a loss position as a result of one or more of the following actions by the owner or the owner's agents: 1) delay adding time-related costs, 2) disruption, 3) changed conditions from those known when the bid was made, 4) change in scope of work, or 5) termination of the contract when the owner has insufficient funds.

These events are beyond the construction contractor's control, and result in events and costs not known when entering into the contract. Therefore, the contractor will attempt to recover additional costs from the owner after contract completion. During the pursuit of a recovery, whether through negotiation, arbitration, or legal means, the contractor will incur additional legal and administrative costs. An important point to note is that because the events and costs in dispute are beyond the scope of the original contract, the contract does not give the contractor the right to a recovery in the typical case. The item is in dispute, and only after settlement is reached does the right to the income become fixed.

A simple example may clarify the significance of this one Blue Book sentence to the industry. A contractor may incur unexpected costs and be forced to pursue a lawsuit to recover his costs and profit from the owner. Although the contract may have been completed within two years, it may take an additional three, four, five, or more years after contract completion to pursue the claim to a final judgment.

Under the proposed application of the look-back method to this situation, the contractor would have to keep the contract open for the additional years required to pursue the lawsuit. When the lawsuit is finally settled a number of years later, the contractor would be required to add that amount to the contract price and allocate it back to the two years during which the original scope of work was being performed.

The contractor would not just be liable for taxes on the recovery, which of course would be wholly appropriate, but would be required to pay the Treasury interest on the taxes from the time the work was being done until the lawsuit was settled. During this time the contractor did not have the money, and did not even have the right to receive it.

Given the compounding of interest, in only a few years the firm's entire claim recovery could be absorbed by taxes and look-back interest, leaving the contractor without reimbursement for his cost overruns.

A further example shows the inequity of the tax policy being applied to construction contractors as compared to the tax treatment applied to other accrual taxpayers in similar situations. In an actual case, an AGC member firm and a supplier of mechanical equipment used in a building project jointly pursued a lawsuit against an owner. After a number of years a judgment was awarded to both the construction contractor and to the supplier.

Under the proposed interpretation of the treatment of claims and recoveries under the look-back method, the construction contractor would have to allocate his recovery back to the time when the work was being done prior to contract completion, and pay taxes and look-back interest on the recovered amount. The supplier, on the other hand, would only be required to record the recovery as taxable income when the lawsuit was settled and would not have to pay interest.

AGC strongly believes that this result would be inequitable. The Committee is urged to incorporate language into the Technical Corrections bill clarifying that Congressional intent was not to include dispute resolutions, claims and lawsuit recoveries under the look-back method.

NICHOLS, RISE & COMPANY
*Certified Public Accountants*

Elleroy C. Nichols, C.P.A.
Clayton L. Rise, C.P.A.
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August 14, 1987

House Ways and Means Committee
Washington, D.C. 20510

Dear Congressional Members:

We are writing to express our concerns for the 1986 Tax Act and the proposed "Technical Corrections Act" as it applies to the construction industry.

Enclosed is a copy of an Associated General Contractor's (AGC) newsletter that reflects their position on various issues under consideration in the "Technical Corrections Bill."

We support the AGC's position on these issues for the reasons discussed below.

#1) "Lookback Rule" applied to claims and lawsuits:

The Joint Committee on Taxation's recent "Blue Book" requires that amounts recovered from claims and lawsuits be taxable and subject to the "lookback" rule in the year the contract work was performed.

The Committee's interpretation is in contradiction of IRS regulations and generally accepted accounting principles regarding when an item is to be reported as income.

These rules require income to be reported when earned if realization is probable and the amount can be reasonably determined. Since claims are disputed issues and amounts, they are includable in revenue when they are settled. Accordingly, such revenue should not be considered as taxable income for purposes of the "lookback" rule.

#2) The AGC position is that a deminimus rule should be applied to exempt certain contract amounts from the lookback rule.

We support the AGC position for having a deminimus rule. However, we encourage an exemption from the lookback rule for contracts which are less than one million dollars without the qualification that it be less than one percent of the taxpayer's average gross receipts for the prior three years.

#3) The AGC position on the method used to determine tax preference income for small contractors is preferable to the much more complex method under IRS regulations. However, we take exception to the inclusion of income earned on uncompleted contracts as a tax preference item.

The 1986 Tax Act essentially requires all contractors to use the percentage-of-completion method to report income on long-term contracts (contracts not completed as of the taxpayer's year-end). The Act suggests that contractors having less than $10,000,000 in average gross receipts for the prior three years may use the completed-contract method to determine taxable income. This is false since the income earned on uncompleted contracts is a tax preference item and, therefore, subject to tax due to the alternative minimum tax computation.

We urge you to give these comments serious consideration when writing the Technical Corrections Bill.

Sincerely,

NICHOLS, RISE & COMPANY
Certified Public Accountants

By Douglas L. Lacey

AGC NATIONAL NEWSLETTER

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# TAX ALERT . . . TAX ALERT

## AGC SEEKS FAIRNESS FOR CONSTRUCTION CONTRACTORS IN "TECHNICAL CORRECTIONS" BILL FOR 1986 TAX REFORM ACT

The sweeping tax reform of 1986 is being addressed in a "technical corrections" act. AGC is representing contractors' interests as the House Ways and Means Committee and Senate Finance Committee consider a number of "corrections." AGC is urging the two committees to:

- override the unwarranted interpretation of claims and lawsuits under the "lookback" rule, as reflected in the Joint Committee on Taxation's recent "Blue Book." The "Blue Book" indicated that income recovered from claims and lawsuits should be considered taxable for the years when the contract work was performed, and that compounded interest would be owed for the entire period from when the work was done until settlement of the claim or suit.

- exempt, from the lookback rule, contracts of less than $1 million that are completed within two years, if the contract price is less than 1 percent of the taxpayer's average gross receipts for the prior three years.

- allow small contractors to use financial statement percentage-of-completion to calculate "alternative minimum tax," rather than using the new, more complicated tax method of percentage-of-completion.

AGC also is working with Treasury and IRS officials to seek equity for contractors on these issues.

A ♦

**AGC ACES**

**"Careers in Construction" Videotape**

- A 14½ minute color videotape on careers available to graduates of college construction and civil engineering programs

- The perfect tool for recruiting high school seniors and "undecided" college students into construction careers

♦ A

WM. R. MONTGOMERY & ASSOCIATES, INC.

July 27, 1987

The Honorable Mr. Dan Rostenkowski
Committee of Ways and Means
1102 Longworth House Office Building
Washington, D. C. 20515

Dear Congressman,

As controller of a corporation which may receive a substantial judgement from a lawsuit for work done during 1979, I am particularly troubled by your Committee's usurious attempt to extract additional taxes by considering such a judgement to be taxable in the year that the work was done. There is absolutely no legitimate reason why this company should be penalized for receiving a judgement which compensates it for its out-of pocket costs that were incurred in 1979.

By pretending the judgement was collected in 1979, your committee is asserting that we had an obligation to pay the taxes in 1979 even though there was no taxable event of any quantifiable magnitude at that time. That's ridiculous! Moreover, the proposal pretends that we had use of the judgement proceeds and were able to use such funds to produce income.

Obviously, if you carry the Committee's proposal to its logical and just conclusion, it becomes a "revenue neutral" proposal. Logic dictates that your committee should grant a deduction to the losing party as if the judgement were paid (expensed) in the year the work was performed. Therefore, the government should pay the losing party interest on the overpaid taxes for the entire period from when the work was performed until settlement of the suit.

Congressman, I think it's time you start living in the real world. Instead of pretending income was earned in a previous year, why don't you pretend you're a small-business owner and critique the Committee's proposals from that perspective. If you do, I can guarantee this "Alice in Wonderland" proposal will disappear.

Yours truly,

WM. R. MONTGOMERY & ASSOCIATES, INC.

Richard T Meyer

Richard T. Meyer
Controller/Treasurer

RTM/smh

cc: AGC
1957 E. Street, N.W.
Washington, DC 20006

10330 PAGE INDUSTRIAL BLVD. / ST. LOUIS, MISSOURI 63132-1388 / (314) 428-4444

## Section 806

Washington Office

Alliance of American Insurers
1629 K Street, Northwest, Suite 1010
Washington, D.C. 20006
202·822·8811

July 16, 1987

Mr. Robert J. Leonard
Chief Counsel
Committee on Ways and Means
1111 Longworth House Office Building
Washington, D.C. 20515

Re: Technical Corrections Bill - H.R. 2636 - S. 1350
Partnership Taxable Years - IRC Section 706(b)(1)

Dear Mr. Leonard:

The Alliance of American Insurers believes that the rules pertaining to the taxable years of partnerships should be amended to allow partnerships that are pools of insurance companies to have a taxable year that is a fiscal year ending no more than 100 days before the end of the calendar year. The Alliance is a trade association of over 175 property/casualty insurance companies that do business in all 50 states and the District of Columbia.

Many insurance companies form "pools" that are in essence joint ventures of companies to underwrite risks that are difficult or impossible for one company to underwrite alone. Some of these pools are voluntary, while others (such as FAIR and windstorm plans that write property insurance, and state residual market plans for auto insurance) are mandated by state governments. Others have been strongly encouraged by either or both state and federal governments in order to provide coverage that may otherwise be unavailable or unaffordable.

A number of these pools file partnership returns. The partners, being insurance companies, are all calendar year taxpayers. The pools, however, have generally adopted a fiscal year ending one or two months before the end of the calendar year. This is done to make it possible for the member insurers to report their shares of the pool's experience on the insurers' own annual statements, effective December 31 of each year, that must be filed with the states. If the pools could not report until the end of the calendar year, the member insurers would find it very onerous, if not impossible, to report the pools' data in their own annual statements.

As amended by the 1986 Tax Reform Act, however, Internal

Revenue Code Section 706(b)(1) would require such partnerships to adopt the calendar year as their taxable year, since that would be the taxable year of the "majority interest" in such partnerships, the insurance companies. The Congress' purpose in enacting this rule was to avoid the deferral of taxable income that may occur when partnerships and their members have different taxable years. Most of these pools, however, write only business that the voluntary insurance market is unwilling to write, the business is unprofitable much more often than not and the possibilities for tax deferral nonexistent. This rule will make it more difficult for these pools to operate and may retard their formation. These pools have been one way in which the insurance industry has met the need for coverage in lines of insurance that have been difficult to write over the last several years, and we believe that they should not be penalized by tax law.

We believe that the following amendment should be added to H.R. 2636 and S. 1350:

> "(B) Subparagraph (C) of section 706(b)(1) of the 1986 Code is amended by adding the following sentence:
>
> > For purposes of this subparagraph, a business purpose may include facilitating the efforts of partners to comply with requirements for including their shares of partnership items in financial reports required to be provided by the partners for any substantial nontax purpose to -
> >
> > > (i) the Federal Government or any agency thereof, or
> > >
> > > (ii) a State government or any agency thereof,
> >
> > provided that the fiscal year so determined shall not end more that 100 days before the date otherwise required by subparagraph (B)."

This amendment to the "business purpose" exception to the calendar year requirement would enable the pools affected to continue to provide their information to their members on a timely basis, while providing no tax avoidance opportunities. We urge that the Ways and Means Committee adopt this amendment to the technical corrections bill.

Sincerely,

Stephen W. Broadie
Senior Counsel - Taxation and Finance

CENTRAL COAST PATHOLOGY CONSULTANTS, INC.
KARL E. KIRSCHNER, M.D.    DAVID M. LAWRENCE, M.D.
STEVEN B. JOBST, M.D.
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TELEPHONE 805-543-0398

July 7, 1987

The Honorable Dan Rostenkowski
HOUSE WAYS & MEANS COMMITTEE
Room 1102 Longworth House Office Bldg.
Washington, D. C.   20515

Dear Mr. Rostenkowski:

I would like to see the 1986 Act provisions repealed which require partnerships, S corporations and personal service corporations to conform their tax years to the calendar year.

First, it seems to me grossly unfair that certain small corporations should be singled out for this change. Possibly I could accept the law if all corporations in the United States were treated in the same manner. However, that is not the apparent aim of these provisions. As medical specialists providing a service via referral, our business is cyclical just as many other corporate entities are within this country.

Second, we have contracts with hospitals, clinics, and other out-patient arrangements which will have to be amended if this law is not repealed.

Third, our retirement and employee benefit plans (we have 15 employees) will need to be altered. These plans have already been changed twice within the last four years, at no small expense, to comply with changing laws. I object to the expense of changing these plans yet again.

Fourth, our fiscal year coincides with a natural business year for us coming as it does between our busiest and least busy periods. This would not be the case if we were forced to align our fiscal year with the calendar year.

And last, it would seem to me to be in the public interest and in the interest of the IRS to encourage staggered tax return filing dates. It seems only reasonable to spread these demands throughout the year to alleviate the heavy workload that has precipitated processing problems in recent years.

Thank you for your consideration of my viewpoint.

Sincerely,

David M. Lawrence, M. D.

National Association NAII of Independent Insurers

499 SOUTH CAPITOL ST., S.W., SUITE 401, WASHINGTON, D.C. 20003
202/484-2350

Darrell Coover
Senior Vice President
Government Relations

August 19, 1987

Mr. Robert J. Leonard
Chief Counsel
Committee on Ways and Means
1111 Longworth House Office Building
Washington, D.C. 20515

Re: Technical Corrections Bill - H.R. 2636 - S. 1350
Partnership Taxable Years - IRC Section 706(b)(1)(C)

Dear Mr. Leonard:

The purpose of this letter is to advise you that the National Association of Independent Insurers ("NAII"), an association of more than 500 property and casualty insurance companies doing business in all 50 states and the District of Columbia, endorses the recommendation of the Alliance of American Insurers ("Alliance"), as set forth in a letter to you dated July 16, 1987, that the rules pertaining to the taxable years of partnerships be amended to permit partnerships consisting of pools of insurance companies to utilize taxable years ending no more than 100 days before the end of the calendar year. A copy of the Alliance's letter, which outlines the reasons such an amendment is necessary and suggests appropriate statutory language, is attached.

NAII urges the Committee on Ways and Means to adopt the amendment to section 706(b)(1)(C) of the Internal Revenue Code of 1986, as proposed by the Alliance.

Sincerely,

Darrell Coover
Senior Vice President-Government Relations

HOME OFFICE, 2600 RIVER ROAD, DES PLAINES, ILLINOIS 60018-3286 PHONE 312/297-7800

Shawmut

Robert G. Ripley, Jr.
Vice President

July 17, 1987

Robert J. Leonard
Chief Council
Committee on House Ways and Means
U. S. House of Representatives
1102 Longworth House Office Building
Washington, DC 20515

RE: HR2636 Technical Corrections Bill of 1987

Dear Mr. Leonard:

On behalf of Shawmut Corporation's Central Tax Unit, of which I am employed by, and the Massachusetts Bankers Association, of which I am a member, please read the following:

First off, to make retroactive the switching of Common Trust Funds to a calendar year end for tax years beginning after December 31, 1986 would truly be a hardship for banks with all that is going on this year. The changing of fiscal year end trusts and the paying of federal estimates, to name a few, are enough in themselves for one year. To add another piece to the puzzle this year would only increase the compliance nightmare required by Fiduciaries.

Secondly, I fully support the ABA in urging that a November 30 fiscal year end be permitted for the Common Trust Funds. But, only if it were for years beginning after December 31, 1987.

The most logical plan in my opinion, would be for the Common Trust Funds to be permitted to be on an October 31 fiscal year end. In any case, allowing the Common Trust Funds to file on a fiscal year end would most certainly cause less of a compliance nightmare.

My final thought is this; that legislation not be passed making it retroactive for Common Trust Funds to be filed on calendar year ends for years beginning after December 31, 1986, but rather legislation be passed permitting Common Trust Funds to remain on fiscal year ends, say either October 31 or November 30, beginning with tax years after December 31, 1987.

I look forward to hearing any comments or questions you might have and can be reached at (617) 793-4161.

Respectfully,

Robert G. Ripley, Jr.
Vice President

Central Tax Unit, Department 6-15, P.O. Box 2032, Worcester, Massachusetts 01613-2032

**UNITED MISSOURI BANK**
**of KANSAS CITY, n.a.**

Personal Trust Division

July 7, 1987

Robert J. Leonard, Chief Counsel
Committee on Ways and Means
U. S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Dear Mr. Leonard:

I am writting to comment on the Technical Corrections Bill of 1987 (H.R. 2636) and will address my comments to Sec 108(e) of the bill; Sec. 806 of the Reform Act and Secs. 706, 1378, 441 and 267 of the code which pertains to Accounting Provisions and in particular, the taxable years of certain entities. The entity which I am addressing is common trust funds which is a pass-through entity used by trusts.

The Tax Reform Act of 1986 required partnerships, Subchapter S Corporations and personal service corporations to adopt the tax year of their owners. It was believed that any other year end for these pass-through entities allowed the improper deferral of income and permitted preferential treatment of certain taxpayers at the expense of others. This change of year end would also be less burdensome than other methods of eliminating the deferral. The Technical Corrections Bill of 1987 added common trust funds to the list of entities that would be required to change to a calendar year end.

Common trust funds are a means by which trust accounts can diversify their holdings. This pool of money from the various trusts is used to purchase stocks, bonds or tax exempts and each trust holds a share of this pool. The large majority of trusts that hold the common trust funds are small accounts that would be unable to diversify to the extent necessary to protect the trust from market risks. Of the accounts that hold common trust funds, a majority of them are exempt pension and profit sharing trusts, therefore, the trusts that would be affected by the change to a calendar year are either exempt accounts or small taxable trusts.

The belief that common trust funds allow for a deferral of income would be true only during the first year that a trust holds the fund and this would be offset in the year that the trust terminates. Trusts are also required to pay estimated taxes so both the trusts and the beneficiaries estimated taxes would be based on income generated by common trust funds.

The belief that common trust funds are placed on a fiscal year in order to defer income is erroneous. These funds are placed on a fiscal year because an annual audit is required by an external CPA firm and my experience has been that the audit lasts for approximately six weeks. The calendar year end in a trust department is exceptionally busy since we are processing all year end information at that time and an audit of the funds at the same time could not be performed efficiently. In addition to the normal year end processing, trusts have now been required to go to a calendar year end for tax reporting purposes. Although everything is processed through a computer, all input and output have to be reviewed for accuracy and corrected where necessary.

Tax reporting on a calendar year end for all trusts will typically result in a doubling of the year end work load since most trust departments had an average of one-half of their trusts on fiscal year ends in order to spread the work load. Spreading the work load is more efficient and the return more accurate not only because of the time frame but also because of the ability to retain a permanent, highly trained tax staff. Temporary tax staff is normally not available during tax season for a fiduciary because that area of taxation is highly specialized. Now that all trusts tax year end will be 12/31, we will be required to send a short year K-1 for the fiscal year end accounts and the recipients of these K-1's will spread this income over the succeeding four years. In addition to this, the Technical Corrections Act of 1987 will require them to spread common trust fund income over the next four years.

Programming changes to accommodate the payment of estimated taxes and the change to calendar year end tax reporting have been extensive during the last several months. To require trust departments to change common trust funds to a calendar year end now will require the filing of extensions on a majority of the 1987 returns since it will be impossible to accomplish the programming on a timely basis. This in turn will require the filing of extensions by all beneficiaries receiving 1041 K-1's for 1987.

I am aware of all of the reasons set forth for the change of the common trust fund year end to a calendar year but I believe that this reasoning was oversimplified and did not take into consideration the cost to the taxpaying public or the burden placed on the employees of both the trust departments and the IRS. Any efficient business firm would try to create more revenue by offering a better product at less cost. This section of the Technical Corrections Act of 1987 is trying to create revenue by increasing cost and offering an inferior product.

The fact that the majority of holders of a common trust fund are exempt employee benefit trusts and that the taxable accounts are now paying estimated taxes would seem to challenge the idea that an improper deferral of income has occured. Several banks that I have contacted have their common trust fund year end on 10/31 which is the year end used by our Bank. This two month deferral of income allows us to be more efficient in our processing without unnecessarily delaying the taxation of the income generated by these funds.

I am asking for an unbiased consideration of the facts when you are reviewing the change of the common trust funds year end to 12/31. Should you feel that a change is required, then I ask you to consider the possibility of allowing the year end to be within the last three months of the year. I appreciate your concern for the need to generate revenue and to be fair to all segments of the tax paying public. I hope you also appreciate the trust departments needs and concerns and realize that the net revenue generated after all expenses are written off may be minimal at best. Thank you for your time.

Sincerely,

Dorothy J. Schneider

Dorothy J. Schneider, CPA
Vice President, Trust Tax
United Missouri Bank of K. C.
1010 Grand Ave., 3rd Floor
Kansas City, MO 64106

## Section 811

## COMMENTS OF CENTEX CORPORATION
## RE SECTION 811(c) OF THE TAX REFORM ACT OF 1986

### Revised Special Effective Date Rule for Installment Sales of Real Property by Dealers

Section 811(c) of the Tax Reform Act of 1986 (the "Act") contains the effective date provisions to be used in applying Section 811(a) of the Act (new section 453C of the Internal Revenue Code of 1986, as amended (the "Code"), relating to certain indebtedness treated as payment on installment obligations). Section 811(c) of the Act generally provides that, with certain exceptions, Section 811 of the Act will apply to taxable years ending after December 31, 1986, with respect to dispositions after February 28, 1986. Section 811(c)(6) of the Act generally provides that certain installment obligations with respect to the sale of real property in the ordinary course of a taxpayer's business will be taken into account ratably (i) over three years with respect to installment obligations arising in the first taxable year to which new section 453C of the Code applies and (ii) over two years with respect to the second taxable year with respect to which new section 453C of the Code applies.

Thus, with respect to a calendar year taxpayer, Section 811 of the Act applies to such taxpayer's taxable year ending December 31, 1987. However, with respect to a fiscal year taxpayer, Section 811 of the Act applies to such taxpayer's taxable year ending in 1987 because such taxable year is the first taxable year of the taxpayer ending after December 31, 1986. The interplay between this effective date and the phase-in of the reduced corporate tax rates under Section 601 of the Act and section 15 of the Code causes calendar year taxpayers to receive a tax benefit not available to fiscal year taxpayers, because gain associated with installment obligations of calendar year taxpayers will be taxed at lower corporate tax rates than comparable installment obligations of fiscal year taxpayers during the first two taxable years to which new section 453C of the Code applies.

However, certain fiscal year taxpayers currently have the ability to change their taxable year from a fiscal year to a calendar year without the prior approval of the Commissioner of Internal Revenue because such taxpayers meet the requirements for such change set forth in Treas. Reg. §1.442-1(c). Following such change in accounting period, such taxpayers will be in the identical tax posture under Section 811(c) of the Act as calendar year taxpayers.

Forcing qualifying fiscal year taxpayers to change their accounting period to the calendar year merely to achieve tax parity with calendar year taxpayers under Section 811(c) of the Act does not foster consistent tax policy and subjects those taxpayers to needless inconvenience. There should be no revenue loss if this change is made because these taxpayers will make the accounting period change if the requested technical correction is not made. In view of the foregoing considerations, the attached proposed statutory language would amend Section 811(c)(6) of the Act to give certain fiscal year taxpayers tax parity with calendar year taxpayers under new section 453C of the Code.

Section 811(c)(6) of the Tax Reform Act of 1986 would be amended to read as follows:

(6) SPECIAL RULE FOR SALES OF REAL PROPERTY BY DEALERS -

(A) IN GENERAL - Except as otherwise provided in subparagraph (B), in the case of installment obligations arising from the sale of real property in the ordinary course of the trade or business of the taxpayer, any gain attributable to allocable installment indebtedness allocated to any such installment obligations which arise (or are deemed to arise) -

(i) in the 1st taxable year of the taxpayer ending after December 31, 1986, shall be taken into account ratably over the 3 taxable years beginning with such 1st taxable year, and

(ii) in the 2nd taxable year of the taxpayer ending after December 31, 1986, shall be taken into account ratably over the 2 taxable years beginning with such 2nd taxable year.

(B) APPLICATION OF SPECIAL RULE TO CERTAIN FISCAL YEAR TAXPAYERS - In the case of a taxpayer who would be entitled, under section 442 of the Internal Revenue Code of 1986 and the regulations thereunder, to change its taxable year to the calendar year, effective January 1, 1987, without the consent of the Commissioner, this paragraph (c)(6) [Section 811(c)(6) of the Tax Reform Act of 1986] and paragraph (c)(1) [Section 811(c)(1) of the Tax Reform Act of 1986] shall be applied with respect to such taxpayer during the first three taxable years of the taxpayer beginning after December 31, 1986 (other than the portion of the third taxable year of the taxpayer after December 31, 1989), so that the portion of the tax liability of the taxpayer attributable to the allocable installment indebtedness of the taxpayer:

(i) shall first become taxable in the taxable year of the taxpayer beginning after December 31, 1986; and

(ii) shall be determined:

(I) for purposes of subsection (a) [Section 811(a) of the Tax Reform Act of 1986] as if the taxable year of the taxpayer had been changed to the calendar year, effective January 1, 1987; and

(II) by applying the tax rate to such portion as would be applied if the taxpayer had changed its taxable year as described in subclause (I) above.

STEPTOE & JOHNSON
ATTORNEYS AT LAW
1330 CONNECTICUT AVENUE
WASHINGTON, D.C. 20036

MARK J. SILVERMAN
(202) 429-6450

August 12, 1987

Robert J. Leonard, Esquire
Chief Counsel
House Ways & Means Committee
Longworth House Office Building
Room 1102
Washington, D.C. 20515

Dear Rob:

I am writing to propose a technical correction to the 1986 Act dealing with liquidating distributions of installment obligations by S corporations.

The liquidating distribution of an installment obligation acquired by an S corporation in a transaction described in section 453(h) should not result in immediate recognition of the entire deferred installment gain to the S corporation shareholder. S corporation shareholders, like C corporation shareholders and partners, should benefit from installment treatment on the receipt of an installment obligation in liquidation of their corporation. Yet after the 1986 Act, full gain acceleration is required even though the S shareholder may not receive any payments on the obligation until some distant point in the future. This result is contrary to the policy of section 453(h), which is to provide generally similar treatment for the shareholder making a stock sale on the installment method, and the shareholder receiving an installment obligation from his liquidating corporation.

The enclosed submission identifies the problem, makes arguments in support of granting S shareholders installment treatment in a transaction described in section 453(h), and lists points to be considered in any correcting amendment you may decide to draft.

If you wish to discuss this matter further, please call me at the above number.

Sincerely,

Mark

Mark J. Silverman

MJS/jts

Enclosure

cc: Don Longaro, Esq.

# DISTRIBUTIONS OF INSTALLMENT NOTES BY S CORPORATIONS

## I. THE PROBLEM

Section 453(h) provides that, in general, if a corporation is liquidated under section 331 and the shareholder receives an installment obligation acquired by the corporation on the liquidating sale of its assets, the shareholder can report any gain on his stock attributable to the installment obligation as payments are received on the obligation. Section 453(h). Similarly, if a partnership disposes of its assets for an installment obligation and distributes the obligation to a partner in liquidation, the partner will generally report his gain, if any, on the installment method. Treas. Reg. § 1.453-9(c)(2). However, as a result of TRA 1986, if an S corporation sells its assets for an installment obligation and liquidates, its shareholders must recognize the full gain inherent in the installment obligation immediately. Because this treatment for S corporation shareholders violates the policy of section 453(h) and serves no independent policy goal, it should be corrected.

## II. POLICY CONSIDERATIONS SUPPORTING CORRECTION OF THE PROBLEM

### A. Discrimination against S corporation shareholders contravenes the policy of section 453(h)

1. Congress enacted section 453(h) because it believed that the treatment of a shareholder receiving installment obligations from a liquidating corporation should be generally similar to the treatment accorded a shareholder selling his stock to an unrelated third party purchaser on the installment method. S. Rep. No. 1000, 96th Cong., 2d Sess. 21 (1980) (Senate report); _see also_ Preamble to Prop. Treas. Reg. § 1.453-2.
   a. Section 453(h) was intended to facilitate the purchase of a corporate business by providing similar treatment of the seller whether corporate assets or stock is sold. Senate report, _supra_ at 21.
   b. In effect, section 453(h) allows a shareholder to use the installment method whether he sells his stock to an unrelated third person, or to his liquidating corporation in exchange for an unrelated third person's installment note.
2. Section 453(h) originally applied in the context of section 337 liquidations. Although old section 337 was repealed by TRA 86, section 453(h) was retained with little substantive change. Thus, the intent of section 453(h) was reaffirmed by Congress.
3. Section 453(h) evinces no intent that C and S corporation shareholders should receive disparate treatment.
4. If the present treatment of S corporation shareholders is not corrected, the disparity between asset sales and stock sales created by TRA 86 in the context of a liquidating S corporation will continue -- despite Congressional intent to create parity.

B. Requested relief does not affect "General Utilities" repeal

TRA 1986 repealed the "General Utilities" doctrine. C corporations must now recognize gain or loss on liquidating distributions. The repeal of the "General Utilities" doctrine was intended to exact a tax where none had been paid before. Restoring to S corporation shareholders the right to use section 453(h) will not affect this policy. If S corporation shareholders are given the benefit of section 453(h), the same amount and character of gain will be taxed to the same persons. Thus, there should not be significant revenue loss. The issue is primarily one of timing and ability to pay.

C. Taxation based on the "ability to pay" is an important tax policy

A basic tenant of Federal tax policy is that taxpayers should not be forced to liquidate their assets in order to pay taxes. Cf. section 448 (S corporations may use cash method); section 6166 (deferral of estate tax). It is this principle which underpins the installment method. However, an S corporation shareholder receiving installment notes on a liquidating distribution is required to recognize all of the gain, even though actual cash payments may not be received until some distant point in the future.

D. Trap for the unwary

The discrimination against S corporation shareholders engendered by TRA 86 creates a trap for the unwary. If an S corporation shareholder sells his stock, he can use the installment method. Similarly, if he causes his corporation to sell its assets on the installment method and not liquidate, he is entitled to installment method. It makes no sense to require S corporation shareholders to retain corporations merely to collect on notes.

E. S shareholders should receive consistent treatment with C corporation shareholders and partners

Because it serves no policy goal to distinguish S shareholders from other business owners, but indeed violates the policies of the installment sales provisions, S corporation shareholders should receive the same treatment as partners and C corporation shareholders.

F. Section 311

Nonliquidating distributions of installment obligations are taxed currently. However, the current tax applies because Congress has not extended section 453(h) to nonliquidating distributions. Although one objective of TRA 86 apparently was to extend the tax treatment of nonliquidating distributions to liquidating distributions, Congress could not have intended to extend such treatment to liquidating distributions of installment obligations, given its reaffirmation of section 453(h).

G. Congress has recognized that distributions of installment obligations deserve special treatment

The fact that a distribution by an S corporation of other types of appreciated, nonliquid or nontradable property (such as buildings) may result in a current tax is inapposite. Congress has specifically carved out installment obligations for special treatment. See section 453(h).

## III. CORRECTION GUIDELINES

Any correction of this problem must satisfy the following requirements:

A. The requirements of section 453(h) must be met on the distribution of the installment obligation;

B. The distribution must not be treated as a disposition of the installment obligation by the S corporation under section 453B (or otherwise trigger gain recognition under either section 336 or 1363(d));

C. The S shareholder receiving the installment obligation must be taxed on all the gain that would have been realized by the S corporation on the installment sale;

D. The character of this gain must be determined at the corporate level;

E. The shareholder's gain must be taxed under the installment method of reporting; and

F. A corporate level tax must be imposed to the extent required by section 1374.

SPIELBERG, HERMAN & ARONIN
CERTIFIED PUBLIC ACCOUNTANTS
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(404) 843-0843

SOL SPIELBERG, CPA
HOWARD HERMAN, CPA
RONALD M. HERMAN, CPA
R. ASHLEY CORBITT, CPA
PAUL ARONIN, CPA

June 22, 1987

Honorable Dan Rostenkowski, Chairman
House Ways and Means Committee
1102 Longworth House Office Bldg.
Washington, D.C. 20515

Dear Mr. Chairman:

This is in reply to you request for comments on the proposed changes to be included in the Technical Corrections Act.

The Act should make clear that interest paid to refinance a loan, which is deductible according to the proposed amendment, should also include any points that were paid in connection with such loan.

In addition, the technical amendment should clarify that the full amount of the installment received on a capital gain, including interest received will be allowed as passive income in order to offset any losses from passive activities. I am not sure that the draft of the bill I have seen emphasizes the word "full".

While I see no mention of any correction or changes in AII - the installment method reporting procedure, I would seriously urge you and your Committee to consider postponing the effective date of this bill, since it is really not clear as to how you compute the items.

If, as I understand, the so-called 1986 Tax Reform Act was to make things simpler, I believe that both your Committee and Senator Bentsen's Committee should either postpone the effective date of this installment reporting Act or redraw the Act so that it is clear.

I am enclosing in this connection, a report by Professor John A. Bogdanski, that I think will explain the problems we have.

Another item which I feel needs clarification in your bill is the amount of interest paid to the Internal Revenue Service in connection with Schedule C Adjustments.

MEMBER
AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS
GEORGIA SOCIETY OF CERTIFIED PUBLIC ACCOUNTANTS

Former Commissioner Mortimer Caplin has given it as his considered opinion that any deficiency from a Schedule C adjustment is a business related item, and the interest paid to the Internal Revenue Service should be deductible in full. There is, as far as I understand, not anything specific on this point in the discussion of the House, Senate or Conference Committee discussions that addresses this problem. As taxpayers are "stuck" with a 1% higher interest than they receive from the Internal Revenue Service, it would seem to me that interest on business matters should be allowed in full.

If you wish any other information, I would appreciate hearing from you.

I would ask to be put on your mailing list in connection with these amendments, so that I might advise our clients, who of course are small business people, as to what is going on.

Thank you.

Sincerely,

SPIELBERG, HERMAN & ARONIN

Sol Spielberg

Enclosures

(Enclosures have been retained in Committee files.)

MORRIS K. UDALL
2d District of Arizona

235 CANNON HOUSE OFFICE BUILDING
202/225-4065

CONGRESS OF THE UNITED STATES
HOUSE OF REPRESENTATIVES
WASHINGTON, DC 20515

COMMITTEES:
INTERIOR AND INSULAR AFFAIRS
CHAIRMAN
FOREIGN AFFAIRS
OFFICE OF TECHNOLOGY
ASSESSMENT

**Statement of**
**Rep. Morris K. Udall and Rep. Richard A. Gephardt**
**before**
**The House Ways and Means Committee**
**on**
**H.R. 2636, The Technical Corrections Act of 1987**

Mr. Chairman, we want to thank you for the opportunity to present testimony to this committee on H.R. 2636, The Technical Corrections Act of 1987.

We want to bring to your attention a matter that became apparent only after the conference report on last year's tax bill was filed. That matter has not been dealt with in the Technical Corrections Act and, in our view, it should be. It relates to the effective date of the new installment sales provision adopted in the Tax Reform Act of 1986.

Section 811 of the Tax Reform Act amended Section 453C of the Internal Revenue Code and created a new disproportionate disallowance rule for installment sales. The Senate provision for this rule was adopted in the conference report. As stated in the conference report: "The conference agreement generally follows the Senate amendment with certain modifications." (Tax Reform Act of 1986--H. Report 99-841, Vol. II, p. 297.)

Each of the modifications made by the conferees to the Senate provision was specified in the conference report. None related to the effective date. The Senate provision was unequivocal in stating that the new installment sales rule would have an effective date of taxable years "beginning after December 31, 1986." However, in the final language of the conference report to the 1986 Act, the effective date for that new provision was changed to "taxable years ending after December 31, 1986." (Section 811 (c) (1))

It is our understanding that this word change was made at the eleventh hour by staff without any Congressional consultation or discussion. It is our further understanding that the change was made because of a previous error in calculating the original revenue estimates of the Senate installment sales provision.

Mr. Chairman, this committee and the entire Congress are clearly very concerned with the revenue considerations associated with all tax legislation. However, we cannot allow those considerations to take precedence over regular legislative procedure and fairness--particularly in such cases as this one in which the revenue implications are relatively minor.

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In our view, the change made in the effective date was not appropriate, either in terms of legislative procedure or, indeed, in terms of equity. We therefore have introduced H.R. 2089, which would reinstate the original wording.

The substitution of the word "ending" for "beginning" in the effective date significantly changed the operation of the new installment sales provision on fiscal-year taxpayers. We have been advised by a number of taxpayers who happen to have a taxable year other than a calendar year that the new rule will impact on them in a much different, and more adverse, way than on calendar year taxpayers.

The conferees, themselves, were obviously concerned about the immediate impact of the new installment sales rule would have on many taxpayers. The conferees adopted a transition rule which was specifically designed to allow those taxpayers who had been using the installment sales method, particularly homebuilders, time to adjust to the new rule.

The word change we have noted in the effective date went directly against the intent of this transition rule, since it accelerated by up to a year the date on which the new rule would apply to fiscal year taxpayers. For example, the word change meant that the new provision began acting on a taxpayer with a fiscal year ending January 31, nearly ten months before the Tax Reform Act was even signed into law.

We would therefore urge that H.R. 2636 be amended to reinstate the effective date of the new installment sales provision enacted in the 1986 Tax Reform Act to fiscal years beginning after December 31, 1986. That was the date that was included in the Senate bill, and that the conferees had intended to be included in the final conference report.

WELLS AND COMPANY
Certified Public Accountants

204 Hudson Avenue, P.O. Box 250
Newark, Ohio 43055
(614) 349-8616

Robert L. Wells, C.P.A.
Jeffrey M. Priest, C.P.A.

June 22, 1987

Robert J. Leonard, Chief Counsel
Committee on Ways and Means
House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Dear Mr. Leonard:

I'm writing to inform you of my utter disgust and frustration with the new proportionate disallowance rules for reporting installment sales under Code Section 453.

I can't believe our representatives knew what they were doing when they approved this impossible complicated legislation. In my opinion these regulations are just as bad and just as unworkable as the carry-over basis rule of Code Section 1023.

I challenge you to have someone on your staff compute the taxation of a simple installment sale of rental real estate by an individual, where the selling price exceeds $ 150,000.00. Do you realize that this computation requires that you must know the taxpayer's adjusted basis of all other assets held by the taxpayers as of the close of his taxable year? Did you know that this includes the adjusted basis of his household furnishings, his golf clubs, his skate board, his pipe, his personal clothing, his wedding gifts and on and on infinitum.

Did you know that this calculation requires taking into account all indebtedness of the taxpayer, including his unpaid credit cards, home mortgage, car loans, college tuition loans, church pledges and on and on?

I hope you will accept my challenge to try to compute the tax income on a simple installment sale and then I'm sure you will begin to understand how impossible and unworkable these regulations are.

The honest American taxpayer deserves something better; and I ask you to do something to bring about a necessary change in these regulations.

Very truly yours,

Robert L. Wells

Robert L. Wells
Certified Public Accountant

## Section 824

MOGEL ENGINEERING, INC.
REGISTERED CIVIL ENGINEERS
422 Petaluma Blvd. No., Suite A.
Petaluma, California 94952
(707) 763-9044

*EMIL J. MOGEL, JR.*
*R.C.E. 26312*
*BONNIE A. MOGEL*
*R.C.E. 24916*

August 6, 1987

Committee on Ways and Means
1102 Longworth Hob
Washington, D.C. 20515-6348

Attention: Representative Dan Rostenkowsky, Chair

Re: Definitions of Expenses and Capital Expenditures

Dear Sir:

The Tax Reform Measure of 1986 has caused nearly all taxpayers to reconsider their approach for making and spending money and to spend more time guessing the possible tax effects on the financial decisions we do make. As you are well aware many aspects of the new tax law are not clear, and taxpayers in all situations are hoping the IRS regulations that come out in 3 years to interpret this measure match or closely match our individual interpretations when we fill out our tax forms and pay our taxes in less than 1 year.

Our firm specializes in land development; and as a result of the vague law regarding the new definitions of expenses and capital expenditures, our clients have been subject to a surcharge* of 65% by Pacific Gas and Electric Co. (P.G. & E.) for all services and for all sizes of developments from a single parcel-split to large subdivisions. P.G. & E. is justifying this exorbitant surcharge by pointing out that they may be required to depreciate expenditures that have previously been expensed, thus their tax expense will be considerably higher (65% it seems).

We feel that this utility is taking undo advantage of the situation, especially since no other utilites are taking this step. We also see that this is a particularly important issue as extremely large sums of money are expended in every field that are subject to this vaguely written law. What we ask from you and this committee is that you would take the necessary steps and make the necessary decisions to clarify this aspect of the new tax law.

Thank you for your consideration. Your response would be appreciated.

Sincerely,

Emil J. Mogel, Jr.
Registered Civil Engineer

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*Refundable upon definition of the law, but without interest

MOGEL ENGINEERING, INC.
REGISTERED CIVIL ENGINEERS
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(707) 763-9044

*EMIL J. MOGEL, JR.*
*R.C.E. 26312*
*BONNIE A. MOGEL*
*R.C.E. 24916*

August 6, 1987

Public Utilities Commission
505 Van Ness Avenue
San Francisco, CA 94102

Attention: Stanley W. Hulett, President

Re: P.G. & E. 65% surcharge to subdivisions for increased federal taxes.

Dear Sir:

As you are aware, the 1986 Tax Reform Measure changed the way some expenditures are deducted from gross income for federal income tax purposes from expenses to depreciated capital investments. Apparently the IRS has not clearly defined which expenditures are still considered expenses and which are capital investments, and this has left some companies not knowing what their tax liability will be for tax year 1987.

P.G. & E.'s solution to this short-term lack of knowledge is to charge a 65% surcharge to land developers of all sizes for all services required to start and complete land-development projects. We strongly protest the PUC's approval of this exorbitant charge, and respectfully request that you reverse your decision. In addition, we request that you require P.G. & E. to refund the surcharges already collected forthwith. Obviously, there are others ways to plan for the possible increased tax liability since no other utilities are approaching this dilemma by making this prohibitive charge.

Regardless of the final interpretation of this tax law, P.G. & E. is taking an unfair advantage of the situation by collecting interest-free monies which they can invest at a profit. Developers are not in business to provide investment opportunities to P.G. & E.

Thank you for reconsidering this matter.

Sincerely,

Emil J. Mogel, Jr.
Registered Civil Engineer

EJM/kk

cc: Commissioner Donald Vial
Commissioner G. Mitchell Wilk
Commissioner Frederick Duda
Commissioner John B. O'Hanian

**PACIFIC LIGHTING CORPORATION**

Richard A. Jackson
Principal Tax Counsel

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Los Angeles, California 90017
Telephone (213) 689-2460

Mailing Address

P. O. Box 60043
Terminal Annex
Los Angeles, California 90060

July 17, 1987

Mr. Robert Leonard, Chief Counsel
Committee on Ways & Means
House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Re: H.R. 2636, Technical Corrections Act of 1987

Dear Sir:

This letter is being submitted on behalf of Pacific Lighting Corporation and its wholly-owned utility subsidiary, Southern California Gas Company (SoCalGas), with regard to new Internal Revenue Code section 118(b) rendering contributions in aid of construction (CIAC) taxable. While section 824(c)(1) of the Tax Reform Act of 1986 provides that all CIAC received after December 31, 1986 is taxable, the legislative history indicates no clear intention to apply this provision retroactively to cover installment contracts executed prior to the effective date of new section 118(b). Yet, pursuant to the language contained in Act section 824(c)(1), payments received in 1987 and thereafter pursuant to such contracts will be taxable. This is inequitable, particularly in light of the fact that these changes could not have been predicted at the time such contracts were negotiated and, as a result, arguably unintentional.

In the normal course of SoCalGas' business, payments for line extensions and similar work are oftentimes made on an installment basis after completion of the project. Since the terms of the contracts are generally not renegotiable, taxing installment payments that relate to prior-existing contracts will unduly penalize the shareholders and/or customers of SoCalGas and those of other similarly-situated utilities. Consequently, it is respectfully requested that Congress provide that amounts received pursuant to binding contracts in effect before January 1, 1987 be governed by prior law.

Respectfully,

Richard A. Jackson

## Title IX, Section 901

GREAT WESTERN FINANCIAL CORPORATION
GREAT WESTERN SAVINGS

**Michael J. Palko**
SENIOR VICE PRESIDENT

July 15, 1987

Mr. Robert J. Leonard
Chief Counsel
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Dear Mr. Leonard:

We would like to take this opportunity to propose a technical correction to the Tax Reform Act of 1986 (1986 Act) regarding the bad debt deduction of thrifts determined under the percentage of taxable income method (PTI) in Section 593. Specifically, we believe the interaction between the timing of the reduction of the PTI percentage from 32 percent to 8 percent and the timing of the corporate tax rate reduction from 46 percent to 34 percent results in an unintended one time increase in the 1987 effective tax rate of most thrift institutions.

This effective tax rate (ETR) increase is a particularly critical factor to thrifts because, in addition to the tax increase, it will cause most thrifts to incur a direct adverse effect to 1987 earnings. This adverse earnings effect will occur because generally accepted accounting principles (GAAP) that are unique to the thrift industry require the PTI deduction to be treated in a manner which directly affects the financial accounting tax provision and the earnings of a thrift. Since, in most cases, the financial accounting income of a thrift is greater than its taxable income, the 1987 ETR increase will produce a reduction to the earnings of thrifts that will be materially greater than the tax revenue produced by the ETR increase. This loss of earnings and net worth will be particularly damaging to the industry as it attempts to ameliorate its long-term financial problems.

Prior to the 1986 Act, thrift institutions had three bad debts reserve methods available to them: experience, percentage of eligible loans, and percentage of taxable income. The experience and percentage of eligible loans methods were the same as those available to commercial banks. The percentage of

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taxable income method, unique to thrift institutions, allowed a deduction of up to 32 percent* of taxable income if at least 82 percent of a thrift's assets were qualified. A thrift eligible for the maximum PTI deduction was, therefore, able to reduce its effective tax rate from the general corporate rate of 46% to 31.28%.

The PTI deduction was originally provided when thrift institution activities were severly restricted by state and federal regulators. The deduction was intended, at least in part, to compensate thrifts for their inability to compete in certain financial markets and also to encourage their primary activity of providing residential mortgage loans.

In reviewing the thrift bad debt reserve methods for purposes of the 1986 Act, it is noted in both Committee reports that both thrift and non-thrift financial institutions are now competing in many of the same markets due to a loosening of prior restrictions on their activities. In recognition of this situation, Congress, while reducing the tax rate of non-thrift financials from 46% to 34%, decided to retain the ETR of thrifts at 31.28%. This was accomplished by reducing the PTI from 32% to 8% (92% of income taxable at the new corporate tax rate of 34% equals 31.28%). This change significantly "evened the playing field" between thrift and non-thrift financial institutions while continuing to encourage the thrift industry to maintain its unique postion as the major provider of residential home mortgages.

With tax legislation as complex and far reaching as the 1986 Act, anomalies often arise between what was intended and what actually results when the new law is applied. The amendment affecting the PTI deduction for the 1987 taxable year is one such example. The timing of the reduction in the corporate tax rate was not matched with the timing of the reduction in the PTI percentage, causing most thrifts to incur a tax rate higher than 31.28% for tax years beginning in 1987. For example, a calendar year-end thrift will incur a 1987 effective tax rate of 36.8%. For non-calendar year-end thrifts, the 1987 effective tax rates will also vary from 31.28%; the extent of the variance depending upon the particular year-end.

This is clearly not the intended result. The legislative history evidences the desire to lower the corporate tax rate for non-thrift corporations while keeping the rate for thrifts the same. There is no stated or unstated policy reason which would justify a one year tax increase. We, therefore, propose a technical correction for this oversight that would bring the 1987 effective tax rate in line with the pre-1986 Act and post-1987 rate of 31.28%.

We would be happy to discuss this issue in more detail and to provide any additional information you may need. Please feel free to contact me at 213/852-3349.

Sincerely yours,

Michael J Palko

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*As a preference item, the statutory maximum deduction of 40 percent was effectively reduced to 32%.

Section 902

**JIM COOPER**
4TH DISTRICT TENNESSEE

COMMITTEES:
ENERGY AND COMMERCE
SMALL BUSINESS

WASHINGTON OFFICE:
125 CANNON BUILDING
WASHINGTON, DC 20515
TELEPHONE: 202-225-6831

**Congreſs of the United States**
**House of Representatives**
**Washington, DC 20515**

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SUITE ONE
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311 SOUTH MAIN STREET
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CROSSVILLE, TN 38555
TELEPHONE: 615-484-1884

July 14, 1987

The Honorable Dan Rostenkowski
Chairman
Committee on Ways and Means
1102 Longworth House Office Bldg.
Washington, D.C. 20515

Dear Danny,

You are great to give us the opportunity to submit issues of concern for consideration in the hearings on H.R. 2636, the Technical Corrections Act of 1987. I am enclosing a letter from one of my constituents about the effect of Revenue Ruling 87-19, also enclosed, on Industrial Development Bond (IDB) holders in our area.

Please give his comments careful consideration as you look at this issue.

Thank you for giving us the chance to participate in the debate on H.R. 2636 in this way. I'm thankful that you are feeling better and hope you'll be back in full force soon.

Sincerely,

JIM COOPER
Member of Congress

JC/mnp

Enclosure

**The Bean Station Furniture Factory**

June 18, 1987

The Honorable Jim Cooper
United States House of Representatives
Washington, DC 20515

Dear Jim:

I am sorry I was not able to attend your open meeting in Morristown on June 13th. I had already committed to a trip sponsored by the Multiple Sclerosis Society of Knoxville, to help them raise funds.

Jim, there is an Internal Revenue Service Ruling made on March 3, 1987 #87-19 which I feel has a large impact on our district. The reason I say this is because industry in this area has used Industrial Development Bonds very extensively, and this ruling directly effects the interest on these Bonds. The Service has held that if a bank waived its right to increase an interest rate under an interest rate adjustment clause, such a waiver would be a material change in the bond and the bond would be considered reissued. Because the bond would be considered reissued on the date that the waiver occured, the Revenue Ruling found that the reissued bond would be considered acquired on the date of the waiver. For your information, I have enclosed a copy of the Revenue Ruling.

Revenue Ruling 87-19 has not caused significant problems regarding the tax-exemption on industrial development bonds. To maintain the tax-exemption on the bonds, a simple form has to be filed with the IRS, and the bonds would continue to be tax-exempt. Thus, with respect to bond transactions, if the proper forms were filed with the IRS, the bonds would still be tax-exempt to the banks that hold them if the banks waived the interest rate adjustment provisions.

County Line Road • Bean Station, Tennessee 37708 • 615/586-8314

The real problem that Revenue Ruling 87-19 posed, however, is with respect to the deductibility of a bank's interest allocable to its tax-exempt bonds. Under Section 265 (b) of the Internal Revenue Code of 1986, banks are precluded from deducting that portion of their interest expense that is allocable to tax-exempt bonds acquired after August 7, 1986. Because a bank would be deemed to acquire any bond with respect to which it waives the interest adjustment as of the date of the waiver, the bank would lose its interest deduction with respect to the bond, the bank for all practical purposes considers the bond to become taxable.

To correct this problem, a legislative solution probable is required. The solution would involve a simple amendment to Section 265 of the Code. Although I do not know what the precise language for such amendment is, the amendment would basically have to state that a bond would not be considered acquired after August 7, 1986 just because the holder of the bond waived an interest adjustment clause in the bond. The Code would have to include a definition of interest adjustment clause.

Jim, I feel that this Ruling by the Internal Revenue Service has very great cost implication to anyone who has I.D. Bonds and feel that this change should be made.

Most Sincerely,

George

George O. Haggard
Vice President

GOH:lw

cc: Joe Gerard

PETER B. DOTT
45 EAST END AVENUE #7D
NEW YORK NY 10028

July 9, 1987

Robert J. Leonard, Esq.
Chief Counsel
Committee on Ways & Means
1102 Longworth Office Building
Washington, D.C. 20515

Dear Mr. Leonard:

I am writing this letter to you subsequent to conversations with other members of the House Ways & Means Committee in order to appeal to your sense of fairness. I am aware of your extensive interaction with members of the Investment Banking profession. I also realize that these meetings at times have proven none too satisfactory. This letter expresses the viewpoint of an Investment Banking professional who has been involved in our business for nearly 15 years, who entered the industry after three years in government and who has also earned a Masters in Public Administration (MPA) from the University of Washington in Seattle.

My basic fears concerning your treatment of Public Finance issues have been realized in the Tax Reform Act of 1986. However, I think this is a fact of life which many Public Finance professionals must accept. I fully acknowledge previous abuses of the public purpose intent of tax-exempt financing which could have been utilized to help alleviate our deficit ridden economy but instead drained the Treasury of important dollars. However, the law addresses these abuses through sunset provisions, the volume cap inclusions and interim attention to only manufacturing IDB financings.

My comments however address a very particular portion of the Tax Reform Act of 1986, specifically the limitation of the amount available for costs of issuance to 2% of the par value of the bond issue. I would like to address this point with the hope that the provision might be either stricken or amended. This is partially due to the fact that this limitation is ultimately forcing the taxpayer and the small businessman to pay more interest than otherwise necessary had a rational commission structure been enacted which allowed our industry and ancillary professions fair compensation for services rendered.

Securities are sold by commission salespeople who receive a percentage of the amount of their sales. Since time is of great import to these individuals, they tend to gravitate toward those areas in which they a) possess familiarity and/or b) foresee adequate compensation. Very often I have been in the middle of marketing a transaction which is not selling well due to our extremely aggressive pricing and my client has instructed me to increase the sales credit in order to inspire the salesforce to sell more. Frequently the larger sales credit is all that was necessary. Fortunately, I have always worked with very seasoned clients who are aware of these subtleties.

To further demonstrate this point, I am enclosing a generic $10,000,000 twenty year transaction with level debt service. This is a basic "vanilla" term bond issue. This exercise establishes the following points. A $5.00 increase in the sales credit for marketing this issue results in a .04% increase in the net interest rate over a 20 year period.

The alternative to increasing the sales credit is to reprice the bonds. Most repricing occurs in 1/8's although it is not uncommon for repricings to occur in 1/4's in the event an issue is experiencing severe difficulty in the marketplace. The alternative involves pricing the bonds above the market so that the higher rates sell the issue. Which makes more sense: To pay the extra sales credit and keep rates lower or to ignore sales credit and mark the bonds up 12-25 basis points in order to effect their sale? The latter alternative increases interest costs significantly more than the 4 basis points allocable to a $5.00 increase in underwriter's discount. It translates into a materially higher yield than would otherwise be necessary. As the rates are higher, so too is the amount of money not subject to taxation and thus increases funds unavailable to the Treasury. Since underwriters are compensated to a far lesser extent for their risk, they have an incentive to mark the bonds up to a yield at which their underwriting bears little to no risk.

The 2% limitation on bond issues produces several onerous results. First, many fees are being paid "out of pocket" such as legal, feasibility, engineering and et al. This is especially true with smaller transactions because it requires an equivalent effort and expense to process a $5,000,000 issue as a $10,000,000 issue. Therefore if Bond Counsel fees amount to $40,000 in a $5,000,000 deal, printing to $10,000, feasibility study costs to $25,000, management fee to $15,000, the issuer has already incurred a total of $90,000 in expenses without factoring in a host of other fees such as underwriter's counsel ($30,000), rating agency ($5,000 - $10,000), trustee, federal funds (if any), day loans, travel and so forth. This is assuming no sales commission. Generally depending upon the maturity, sales credits range from between 1/8 to 1 point. Given our standard 20 year deal, we would expect a 3/4 point ($37,500) sales credit. Under the law, a $5,000,000 transaction is permitted $100,000 for costs of issuance. Therefore you can see how this limit materially effects smaller issuers of essential purpose bonds.

The aforementioned fees were previously capitalized into the bond issue. Currently, they are being paid out of municipal coffers or businessmen's pockets. The irony is that one of the abuses which began much of this intense scrutiny (i.e. single family mortgage revenue bonds), are allowed 3 1/2% for costs of issuance for issues with a principal value less than $20,000,000. It seems appropriate to either bring these amounts into parity so that all bond issues with a principal value less than $20,000,000 are allowed 3 1/2% for costs of issuance or eliminate the limitation totally. In addition, most transactions of any consequence involve a financial advisor whose function it is to advise issuers whether or not the rates and fees they are being charged are justified given current market requirements.

I hope you receive and accept this letter in the spirit in which it is written. You all have done an admirable job on the tax bill. Tax reform is inherently difficult. My comments are meant to be viewed as addressing a very small technical change which will have a positive impact on the amount of dollars received by the Treasury as well as benefit the taxpayers of states and cities across America. In the event you need to reach me, please call 212-288-8200.

Very truly yours,

Peter B. Dott

THOMSON McKINNON SECURITIES INC.

GENERIC ISSUE

| | |
|---|---|
| Par Value | $10,000,000 |
| Dated Date | 7/1/87 |
| Delivery Date | 7/1/87 |
| Final Maturity | 7/1/2007 |
| Level Debt Service | 7/1/88 through 7/1/2007 |

TABLE A

| | COUPON | UNDERWRITER'S DISCOUNT % FEE PER $1,000 BOND | NIC (%) | TIC (%) |
|---|---|---|---|---|
| | 8% | $10 | 8.0770980 | 8.1339844 |
| | 8% | $15 | 8.1156470 | 8.2017698 |
| DIFFERENCE: (%) | | | <.038549> | <.0677854> |
| BASIS POINTS: | | | <3.855> | <6.779> |
| | 8.1% | $10 | 8.1769734 | 8.2346023 |
| | 8.1% | $15 | 8.2154601 | 8.3027015 |
| DIFFERENCE: (%) | | | <.0384867> | <.0680992> |
| BASIS POINTS: | | | <3.845> | <6.810> |
| | 8.25% | $10 | 8.3266959 | 8.3854270 |
| | 8.25% | $15 | 8.3650439 | 8.4539453 |
| DIFFERENCE: (%) | | | <.038348> | <.0685183> |
| BASIS POINTS: | | | <3.835> | <6.852> |

Table A demonstrates the impact of the $5 differential in costs of issuance upon the amount of the debt service obligation incurred by the taxpayers of the issuers. However, the impact of changes in the underwriter's discount upon the pricing of a bond financing and the resultant difference in the true interest cost is of greatest importance to the issuer. The following table delineates the impact of a different underwriter's discount upon the NIC and the TIC given alternative pricing scenarios at par for the same generic issue.

TABLE B

| | COUPON | UNDERWRITER'S DISCOUNT % FEE PER $1,000 BOND | NIC (%) | TIC (%) |
|---|---|---|---|---|
| | 8.1% | $10 | 8.1769734 | 8.2346023 |
| | 8% | $15 | 8.1156470 | 8.2017698 |
| DIFFERENCE: (%) | | | .061326 | .0328325 |
| BASIS POINTS: | | | 6.13 | 3.28 |
| | 8.25% | $10 | 8.3266959 | 8.3854270 |
| | 8% | $15 | 8.1156470 | 8.2017698 |
| DIFFERENCE: (%) | | | .2110489 | .1836672 |
| BASIS POINTS: | | | 21.10 | 18.37 |

As indicated in Table B, the pricing at par of the issue significantly impacts the NIC and TIC of debt service to maturity. Although the underwriter's discount is $5 per $1,000 bond greater, the incentives which exist for more aggressive pricing result in overall savings of 6.1 basis points (NIC) and 3.3% basis points (TIC) for a 10 basis point differential in price. The overall savings are even more impressive for a 25 basis point price differential: 21.1 basis points (NIC) and 18.4 basis points (TIC).

A comparison of Tables A and B provides further insight regarding the importance of aggressive pricing. Reduction of the underwriter's discount lowers NIC and TIC by approximately 3.8 and 6.8 basis points respectively. However, in conjunction with more aggressive pricing, the higher underwriter's discount provides NIC and TIC savings ranging from approximately 6.1 to 21.1 basis points and 3.3 to 18.4 basis points respectively. Alternatively stated, the difference between the $15 and $10 underwriter's discount costs the isser in NIC and TIC approximately 3.8 and 6.8 basis points respectively. In return however, the issuer receives a savings on NIC and TIC of 6.1 to 21.1 basis points and 3.3 to 18.37 basis points respectively.

For a $10,000,000 issue and a 25 basis point pricing differential, an issuer accrues total savings of $330,363. This amount takes into account the additional $50,000 cost of issuance.

Hopefully this analysis has provided a more complete understanding of the controversy surrounding the level of underwriter's discount and the impact of pricing decisions upon the total debt service obligation incurred by current issuers of tax-exempt securities.

**FINLEY, KUMBLE, WAGNER, HEINE,**
**UNDERBERG, MANLEY, MYERSON & CASEY**

## Comments of the NOCS Group to the Committee on Ways and Means U.S. House of Representatives Regarding Technical Corrections Act of 1987

July 17, 1987

The NOCS Group ("NOCS") wishes to thank the Committee on Ways and Means for the invitation to comment on H.R. 2636, the Technical Corrections Act of 1987. NOCS takes this opportunity to respectfully request that the attached technical correction be included in some form in H.R. 2636. This language clarifies that institutional purchasers of bonds issued to finance the NOCS-owned cold storage facility in the Remount Road Container Yard in North Charleston, South Carolina may continue to deduct 80 percent of the interest paid to depositors which is allocable to those tax exempt obligations. This statement is submitted on behalf of NOCS by its Washington, D.C. legislative counsel, Finley, Kumble, Wagner, Heine, Underberg, Manley, Myerson & Casey.

### A. Description of the Company and Project

NOCS owns and operates a cold storage warehouse facility on the Cooper River in North Charleston, South Carolina through its wholly-owned subsidiary NOCS South Atlantic Cold Storage & Warehouse, Inc. ("South Atlantic"). South Atlantic was selected by the South Carolina State Port Authority (the "Port Authority") to construct and operate a privately-owned facility that could operate more efficiently than an existing state-owned facility in the Port of Charleston. This facility will attract additional vessels to the Port of Charleston. Ships ordinarily dock and unload at one location on the eastern seaboard. That location is generally determined based on the port's refrigerated container storage capacity since that cargo is the most perishable. The City of Charleston has estimated that it derives between $50,000-$60,000 in revenues for ancillary services for each day a freighter is docked in Charleston. We understand that the Remount Road facility has attracted substantial additional import-export traffic to that port.

South Atlantic agreed to build a modern state-of-the-art container facility in exchange for the issuance of a $4 million industrial development bond to defray part of large initial construction costs. The Company began operating the State's refrigeration facility on January 15, 1986, and signed an irrevocable lease with the Port Authority on May 20, 1986, which required the Company to construct a new facility. We understand that the Company was unaware that the Tax Reform Act, which was ultimately enacted in November 1986, would eliminate the deductibility of tax-exempt interest to the institutional purchaser of their bonds.

The bank holding the bonds has raised the rate of interest to the borrower between 3-4% per year based on this tax change, pursuant to the terms of a Financing Agreement. The Ports Authority has been advised that the unforseeable and retroactive increase in South Atlantic's cost of borrowing will cause South Atlantic to raise cargo rates and become uncompetitive with other ports on the eastern seaboard. Recognizing that this situation will threaten Charleston's increased shipping income, the Ports Authority has contacted members of the State's Congressional delegation who have requested that South Atlantic be included expressly in a transition rule to Section 902(f)(3)(L) of the Act. That section already excludes "Charleston,South Carolina waterfront projects" from the provision eliminating the ability of financial institutions to deduct the interest paid to depositors which are allocable to tax-exempt obligations (see Exhibit "A" attached).

## B. Proposed Revision to the Act

The proposed technical correction to an existing transition rule contained in Section 902(f)(3)(L) of the Act (see Exhibit "B" attached) would specifically list the waterfront projects entitled to transition relief. It would clarify that institutional purchasers of tax-exempt bonds issued for the South Atlantic warehouse project could continue to deduct 80 percent of the interest paid to depositors which are allocable to those tax exempt obligations. The existing transition rule currently provides only a general exemption for "Charleston, South Carolina waterfront projects."

The revenue cost of this clarification is de minimus according to the calculations of Ernst & Whinney (see Exhibit "C" attached). Those calculations suggest that the revenue cost of this classification ranges between $520,000-$1.2 million over the 31 year life of the loan.

## C. Arguments in Support of Revision

The provision suggested above would accord to South Atlantic the same tax treatment upon which it justifiably relied when it contracted with the Port Authority to construct a new cold storage warehouse on May 20, 1986 based. This contract was based on State assurance of the availability of the tax-exempt financing. South Atlantic was alerted to the prospect that Section 902 could result in higher interest on bank-held tax-exempt debt late in the tax reform process. They contacted their Congressional representatives and were under the impression that this transaction would be accorded transition relief in the Act. When the legislative language of the Act was reviewed, it contained an exemption for Charleston waterfront projects. South Atlantic was advised that this applied to them. The bond counsel for the institutional lender analyzed the provision and examined its legislative history. He reported that the bank could not rely on this exemption because the Remount Road facility was not specifically mentioned and because there was a waterfront project on the Charleston harbour to which this provision was specifically intended to apply.

The inclusion of this provision has the support of the Port Authority and important members of the South Carolina Congressional delegation. It will result in competitive rates for cargo storage and assist in increasing the utilization of the Charleston harbour. It is, therefore, respectfully requested that some form of this technical correction be included in the Technical Corrections Act of 1987.

EXHIBIT A

**south carolina state ports authority**
Post Office Box 817, Charleston, South Carolina 29402 Telephone 803/723-8651

April 20, 1987

Mr. Kerk Spong
Legislative Assistant
Office of Senator Strom Thurmond
218 Russell Senate Office Building
Washington, DC 20510-4002

Dear Mr. Spong:

On behalf of the South Carolina State Ports Authority, this is to confirm our strong support of a request by NOCS South Atlantic Cold Storage & Warehouse, Inc., to be included in a transition rule to Section 902 of the Tax Reform Act of 1986. Section 902(f)(3)(L) of the Act currently excludes "Charleston, South Carolina waterfront projects" from a provision eliminating the ability of financial institutions to deduct the interest paid to depositors which are allocable to tax-exempt obligations.

Like the other projects contemplated in the Act as now drawn, the cold storage warehouse is also located on port terminal properties owned by the Ports Authority. The Authority offered to issue industrial development bonds to finance a portion of the warehouse construction, but NOCS relied on the then lower interest rates on tax-exempt debt. In fact, NOCS has committed to incur substantial debt to construct a project of great benefit to the local area in general, and specifically to the Port of Charleston and the Ports Authority. The Authority's obsolete cold storage warehouse and freezer is to be demolished in contemplation of successful business operations by NOCS. But, the purchaser of NOCS' bonds has now increased its interest rate by 3% - 5% due to the loss of a valuable deduction, and NOCS will have no choice but to offset its increased debt service costs by increasing its rates to store refrigerated cargo. Without the requested help, the Port will undoubtedly lose significant revenues because commercial shippers will elect to load or unload at ports with facilities offering more competitve rates.

Attached is the specific language requested by both interested parties to expand the existing transition rule in fairness to NOCS and for the benefit of the Port of Charleston and the citizens of South Carolina. Again, for the Ports Authority, I reiterate the Authority's strong support of this request, and we greatly appreciate your and the Senator's efforts in this matter. Please telephone me if I may be of further assistance.

Sincerely,

WM Lawrence

W. M. Lawrence
Chief Financial Officer

ATTACHMENT

Section 902 (f) (3) (L) of the Tax Reform Act of 1986 is amended to read as follows:

(L) Charleston, South Carolina, waterfront projects which include two festival market place projects at Union Pier Terminal and the Remount Road Container Yard, State Pier No. 15, at North Charleston Terminal.

## EXHIBIT B

### Proposed Amendment to Financial Institution Provision of Tax Reform Act of 1986 Re: Charleston Waterfront Project

Section 902(f)(3)(L) of the Tax Reform Act of 1986 is amended to read as follows:

> (L) Charleston, South Carolina, waterfront projects which include: two Festival Market Place projects at Union Pier Terminal and the Remount Road Container Yard, State Pier No. 15, at North Charleston Terminal.

---

## EXHIBIT C

Ernst & Whinney

920 One Shell Square
New Orleans, Louisiana 70139

504/581-5691

March 5, 1987

HAND DELIVERED

Mr. James Farguson
New Orleans Cold Storage
& Warehouse Co., Ltd.
Post Office Box 26308
3401 Alvar Street
New Orleans, Louisiana 70186

Dear Jim:

At your request, I have calculated (using simplified and, in certain instances, highly subjective assumptions outlined below) the total estimated dollar impact on federal income tax collections if the NOCS loan from Hibernia is granted pre August 8, 1986 tax treatment under the provisions of the 1986 Tax Reform Act (TRA). Based upon the assumptions utilized, the present value of the Treasury's net tax collections would be approximately $520,000 lower over the 31 year life of the loan in a "best case" scenario. In a "worst case" scenario, the decrease in tax collections would approximate $1,220,000 over the 31 year life of the loan.

The primary difference in the two scenarios is that the best case assumes a constant interest rate and uses present value factors. The worst case assumes increasing interest rates and does not discount the future lost tax collections back to the present time. Under the provisions of the 1986 TRA [§265(b) and §291(e)(1)(B) of the 1986 Internal Revenue Code], the interest income on the $4,000,000 loan from Hibernia could be tax-exempt to Hibernia under certain circumstances even if the loan was entered into after August 7, 1986. The 1986 TRA would, however, disallow Hibernia an interest deduction, for tax purposes, equal to 100% of the amount of interest expense inputed to the borrowing the Bank incurred to fund the loan. The interest expense deduction disallowance would be imposed because the loan to NOCS by HNB was entered into after August 7, 1986.

If NOCS is successful in obtaining transition relief through the proposed Technical Corrections Act, the loan would be considered to have been entered into before August 8, 1986. The interest expense imputed to the loan would still be subject to a disallowance, but the amount of the disallowance would be limited to 20%. As a result, Hibernia would be able to offer NOCS a lower interest rate.

The following assumptions were used in the calculation of the effect of considering the NOCS loan as a pre August 8, 1986 loan:

- NOCS borrowed $4,000,000 from Hibernia on January 1, 1987.

- During 1987, NOCS pays interest only and makes no principal reductions.

- The loan matures in thirty-one years. In each year after 1987, NOCS will make monthly principal payments of $11,111 (annual principal payments of $133,332). Interest will be paid monthly and will be computed based upon the principal outstanding at the end of each month.

- If the transition relief is not granted, the interest rate in the best case scenario is assumed to be 9% (the rate at January 1, 1987) over the 31 year period to maturity. In the worst case scenario, the interest rate is assumed to be 9% in years 1-5, 10% in years 7-11, 11% in years 12-16, 12% in years 17-21, and 13% in years 22-31.

- If transition relief is granted, the interest rate in the best case scenario is assumed to be 6% over the 31 year period to maturity. In the worst case scenario, the interest rate is assumed to be 6% in years 1-6, 6.75% in years 7-11, 7.50% in years 12-16, 8.25% in years 17-21, and 9% in years 22-31.

- If transition relief is granted, the 20% interest expense disallowance to Hibernia is assumed to be $40,000 per year in years 1-10, $30,000 in years 11-20, and $20,000 in years 21-31. (These estimates are highly subjective based upon recently published financial information.)

- The federal tax rate applicable to both NOCS and Hibernia is assumed to be 34% in all years.

The effect of the transition relief on Treasury tax collections is computed by comparing tax collections with and without transition relief, as follows:

| | Best Case Scenario | Worst Case Scenario |
|---|---|---|
| **Without Transition Relief** | | |
| Interest income taxable to Hibernia | $5,775,000 | $6,660,033 |
| Interest expense deductible by NOCS | (5,775,000) | (6,660,033) |
| Net Effect on Tax Collections | $ -0- (A) | $ -0- (A) |
| **With Transition Relief** | | |
| Interest income taxable to Hibernia | $ -0- | $ -0- |
| Interest expense deductible by NOCS | (3,850,000) | (4,515,022) |
| Interest expense deductions disallowed to Hibernia | 920,000 | 920,000 |
| | 2,930,000 | 3,595,022 |
| Assumed tax rate | x 34% | x 34% |
| | 996,200 | 1,222,307 |
| Effect of tax collections without transition relief | -0- (A) | -0- (A) |
| Decrease in Tax Collections | $ 996,200 | $1,222,307 |
| Net Present Value (discounted at 8%) of Decrease in Tax Collections | $ 518,885 | N/A |

If you have any questions about this matter, please call me.

Very truly yours,

Arthur J. Parham, Jr.
Senior Manager

AJP:ze

LAW OFFICES
OBERMAYER, REBMANN, MAXWELL & HIPPEL
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S.E. CORNER 15TH AND CHESTNUT STREETS
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WARREN W. AYRES
DIRECT DIAL (215) 665-3124

July 16, 1987

**FEDERAL EXPRESS**

Robert Leonard, Esquire
Chief Counsel
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

RE: H.R. 2636 - TECHNICAL CORRECTIONS ACT OF 1987

Dear Mr. Leonard:

On behalf of the State Public School Building Authority of the Commonwealth of Pennsylvania (the "Authority" or "SPSBA"), I request that Section 109(b) of the Technical Corrections Act of 1987 (the "TCA") be supplemented as set forth in Exhibit A hereto.

I. The Authority.

The Authority is a public corporation and governmental instrumentality of the Commonwealth of Pennsylvania. It was formed under the State Public School Building Authority Act of July 5, 1947. Its primary function is to acquire finance, refinance, construct, improve, furnish, and equip school buildings for Pennsylvania local public-school districts, public vocational-technical schools, and public community colleges (the "Districts"). The Authority issues bonds to pay for the construction, reconstruction, or rehabilitation of Pennsylvania school buildings. These bonds are intended to qualify as non-private activity bonds under the Section 141 of the Internal Revenue Code of 1986, as amended (the "Code").

The Authority has been issuing bonds for Districts since 1960 under an open-ended indenture. All bonds issued under this indenture have an "AA-" rating from Standard and Poors. This financing vehicle has enabled over 244 Districts to finance and refinance projects economically and effectively. Due to the Authority's negotiating power and its ability to combine financings of several Districts, issuance costs and related fees associated with Authority bond issues have been reduced substantially. As a result of these reduced costs, the total amount of bonds issued for Pennsylvania public school facilities has been less than would otherwise have been the case. Furthermore, due to their national recognition, Authority bonds have typically traded at lower interest rates than bonds issued directly by the Districts. Because of the cost effectiveness of issuing bonds through the Authority, Districts have issued less debt, paid lower annual interest rates, reduced their annual debt service expenditures, and retired their debt earlier.

So far as we are aware, no other State has a similar financing mechanism for public school facilities.

Districts are not obligated to finance their facilities through the Authority. Most Districts may obtain such financing by issuing general-obligation bonds themselves.

## II. Impact of 1986 Tax Reform Act.

As amended by Section 902 of the Tax Reform Act of 1986 (the "Act"), Code Section 265(b) generally denies banks, thrift institutions, and other financial institutions a deduction for that portion of their otherwise allowable interest expense that is allocable to tax-exempt obligations acquired after August 7, 1986. However, under Code Section 265(b)(3), as amended by the Act, there is an exception to this disallowance rule for "qualified tax-exempt obligations"--i.e., obligations which are not private activity bonds and which are issued by an issuer which reasonably anticipates to issue not more than $10 million of tax-exempt obligations (other than private activity bonds) during the calendar year.

Most Districts do not issue more than $10 million of tax-exempt obligations during any calendar year. As a result, bonds issued directly by Districts to finance their facilities will generally be "qualified tax-exempt obligations" under Code Section 265(b)(3).

The Authority has issued tax-exempt bonds well in excess of $10 million annually in prior years, and hopes to continue to do so. As a result, bonds issued by the Authority for the benefit of a particular District will apparently not be "qualified tax-exempt obligations" under Code Section 265(b)(3) as it currently exists, regardless of the size of the bond issue, and regardless of whether or not any other tax-exempt obligations have been issued by that District during the calendar year.

This disparity in tax treatment between bonds issued directly by Districts ("District Bonds") and bonds issued by the Authority for the benefit of school districts ("Authority Bonds") tends to make it less attractive for Districts to obtain financing through the Authority. Indeed, the Act has drastically curtailed the ability of the Authority to function as a financing vehicle for Districts. Code Section 265(b)(3) allows District Bonds to be priced more aggressively than Authority Bonds for the same project, since the interest "subsidy" provided by Code Section 265(b)(3) allows District Bonds to bear lower interest rates. This interest "subsidy" more than outweighs the real issuance-cost savings which can still be obtained by financing projects with Authority Bonds. Thus, Code Section 265(b)(3) is having the effect of driving out of business the most efficient financing mechanism for Pennsylvania public school facilities.

This adverse effect on Authority financing is undesirable. The issuance costs of District Bond issues are usually larger than the issuance costs of comparable Authority Bonds, since Districts normally lack the negotiating power and economies of scale which the Authority can bring to bear to reducing issuance costs. And because of this disparity in issuance costs, the face amount of District Bonds issued for a particular project is typically larger than would be the case with Authority Bonds. These effects contravene two of the primary purposes of the 1986 Tax Reform Act--namely, to decrease bond issuance costs, and to decrease the total amount of tax-exempt bonds that are issued.

Because of the difference in issuance costs, and because of the higher S&P rating which Authority Bonds typcially enjoy compared to District Bonds, the true interest cost of District Bonds is usually greater than the true interest cost of comparable Authority Bonds. However, the advantage in true interest costs of Authority Bonds is now masked by the interest "subsidy" which Code Section 265(b)(3) currently provides to most District Bonds, but not to Authority Bonds. This artificial disparity should be eliminated.

in Code Section 265(b)(3). The blue line shows the yields on Authority Bonds which would be expected under current financial conditions if the benefit of Code Section 265(b)(3) were extended to Authority Bonds.

EXHIBIT C compares the principal amounts, total debt service, and average interest rates under current financial conditions of:

> Authority Bonds without the benefit of Code Section 265(b)(3) (first column);
>
> District Bonds with the benefit of Code Section 265(b)(3) (second column); and
>
> Authority Bonds which could be issued if the benefit of Code Section 265(b)(3) were extended to Authority Bonds (third column).

The disparities in principal amounts result from the differences in issuance costs. Exhibit C shows that if the benefit of Code Section 265(b)(3) were entended to Authority bonds, school-district projects could be financed with smaller bond issues (due to smaller issuance costs) and smaller total debt service.

EXHIBIT D sets forth the calculations by which the numbers of Exhibit C were derived.

Exhibits B, C, and D were prepared by A.H. Williams & Co.

### IV. Proposed Change to Technical Corrections Act.

Section 109(b) of the Technical Corrections Act of 1987 would amend Section 902 of the Act in several respects. On behalf of the Authority we request that TCA Section 109(b) be expanded to include an additional amendment to Section 902 of the Act, as set forth in Exhibit A. The purpose of this additional amendment is to eliminate the artificial disparity in tax treatment under Code Section 265(b)(3) between District Bonds issued directly by school districts and Authority Bonds issued by the Authority for the benefit of school districts.

If you have any questions about this proposal, please contact any of the following:

### III. Illustrations.

The graph on EXHIBIT B illustrates the effect which Code Section 265(b)(3) is having on the yields of Authority Bonds. The red line shows the yields on Authority Bonds which are expected under current financial conditions without any change

Mr. Donald Bagenstose, Executive Director, State
Public School Building Authority - (717) 787-3612

Mr. Denis J. Carlson, Vice President, A.H. Williams
& Co. - (215) 732-9895

Warren W. Ayres, Esquire, Obermayer, Rebmann, Maxwell
& Hippel - (215) 665-3124

Yours very truly,

Warren W. Ayres

## Exhibit A

Add the following at the end of Section 109(b)(5)(A) of the Technical Corrections Act of 1987:

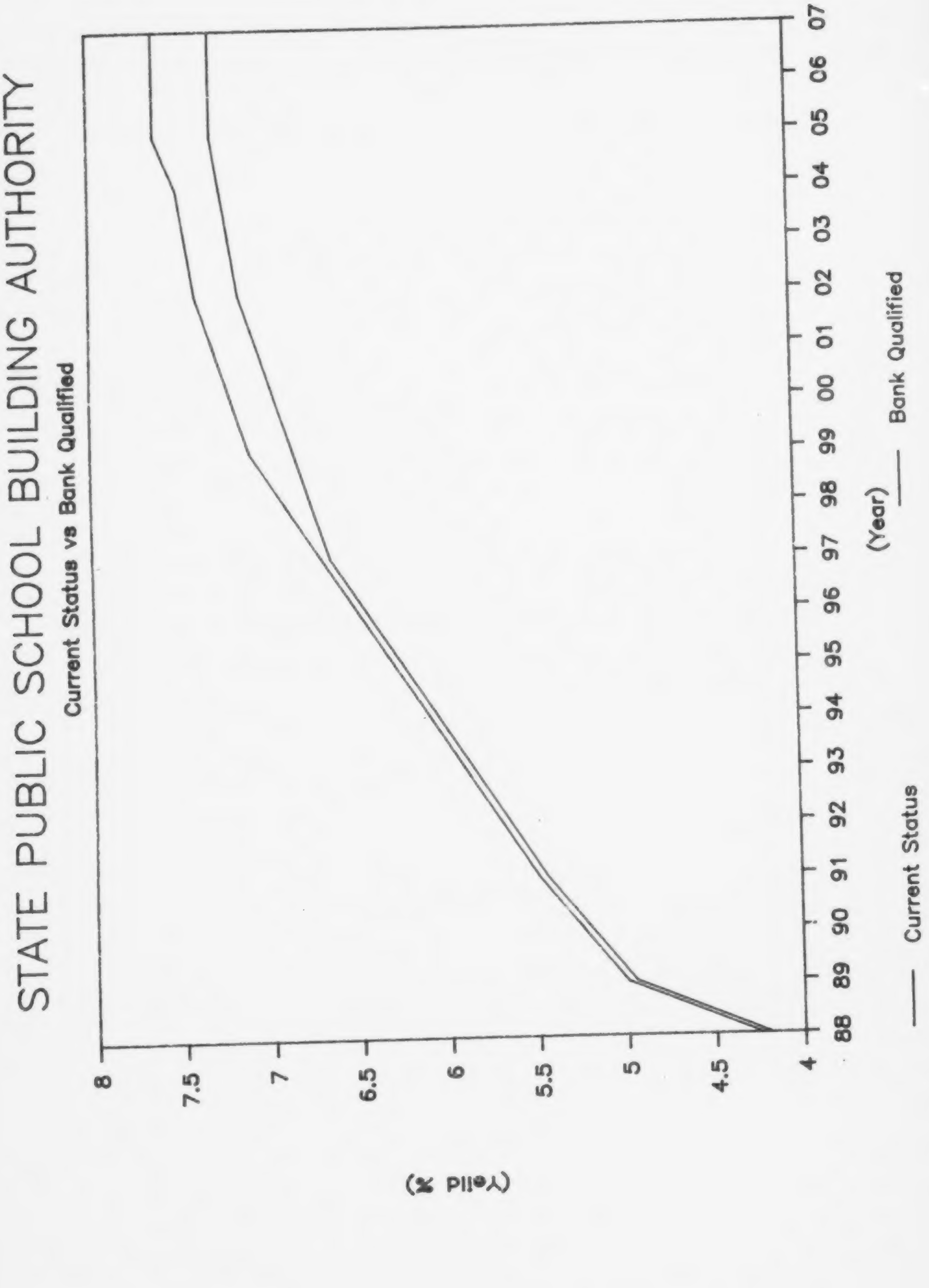
"(I) TREATMENT OF CERTAIN CONDUIT ISSUERS. In the case of an obligation--

(i) which is issued by a State agency or instrumentality formed for the purpose of financing the acquisition, construction, improvement, and equipping of public educational facilities in such State, and

(ii) substantially all of the proceeds of which are loaned by such agency or instrumentality to a school district (or similar political subdivision) of such State for such purpose,

such school district (or similar political subdivision) shall be treated as the "issuer" for purposes of this paragraph in order to determine whether or not the obligation issued by such agency or instrumentality is a "qualified tax-exempt obligation" for purposes of subparagraph (A)."

EXHIBIT B


STATE PUBLIC SCHOOL BUILDING AUTHORITY
Current Status vs Bank Qualified
(Yield %)
8
7.5
7
6.5
6
5.5
5
4.5
4
88
89
90
91
92
93
94
95
96
97
98
99
00
01
02
03
04
05
06
07
(Year)
Current Status
Bank Qualified

# Exhibit C
# Results of Bank Qualification

## $5,000,000 Project

| | SPSBA | Local G.O. | SPSBA with Qualifications |
|---|---|---|---|
| Principal | $5 ,160,000.00 | $5,195,000.00 | $5,160,000.00 |
| Total Debt Service | $ 9,870,016.25 | $9,761,990.00 | $9,696,747.50 |
| Average Interest Rate | 7.243% | 6.999% | 6.999% |

## $9,500,000 Project

| | SPSBA | Local G.O. | SPSBA with Qualifications |
|---|---|---|---|
| Principal | $ 9,790,000.00 | $ 9,830,000.00 | $ 9,790,000.00 |
| Total Debt Service | $18,720,031.25 | $18,456,967.50 | $18,397,100.00 |
| Average Interest Rate | 7.243% | 6.998% | 6.999% |

## EXHIBIT D

### STATE PUBLIC SCHOOL BUILDING AUTHORITY
(Commonwealth of Pennsylvania)

### $5,000,000 PROJECT COST

### 20 YEAR BOND ISSUE

### SOURCES AND USES OF FUNDS

| ESTIMATED SOURCES OF FUNDS | |
|---|---:|
| Bond Proceeds | $5,160,000.00 |
| | $5,160,000.00 |

| ESTIMATED USES OF FUNDS | |
|---|---:|
| Construction | $5,000,000.00 |
| Insurance Premium | 64,155.11 |
| Issuance Costs | 23,604.89 |
| Underwriter's Discount | 72,240.00 |
| | $5,160,000.00 |

### STATE PUBLIC SCHOOL BUILDING AUTHORITY
(Commonwealth of Pennsylvania)

### $5,000,000 PROJECT COST

### 20 YEAR BOND ISSUE

### ESTIMATED ISSUANCE COSTS

| | |
|---|---:|
| Bond Counsel | $15,000.00 |
| Initial Trustee Fees | 3,000.00 |
| Printing | 5,000.00 |
| Miscellaneous | 604.89 |
| TOTAL | $23,604.89 |

# STATE PUBLIC SCHOOL BUILDING AUTHORITY
(Commonwealth of Pennsylvania)
$5,000,000 PROJECT
20 YEAR INSURED ISSUE

DEBT SERVICE FROM 07/01/87

| DATE | PRINCIPAL | RATE | INTEREST | TOTAL P+I | ANNUAL D/S |
|---|---|---|---|---|---|
| 01/01/88 | | | 177,256.25 | 177,256.25 | |
| 07/01/88 | 140,000 | 4.250 | 177,256.25 | 317,256.25 | 494,512.50 |
| 01/01/89 | | | 174,281.25 | 174,281.25 | |
| 07/01/89 | 145,000 | 5.000 | 174,281.25 | 319,281.25 | 493,562.50 |
| 01/01/90 | | | 170,656.25 | 170,656.25 | |
| 07/01/90 | 150,000 | 5.250 | 170,656.25 | 320,656.25 | 491,312.50 |
| 01/01/91 | | | 166,718.75 | 166,718.75 | |
| 07/01/91 | 160,000 | 5.500 | 166,718.75 | 326,718.75 | 493,437.50 |
| 01/01/92 | | | 162,318.75 | 162,318.75 | |
| 07/01/92 | 170,000 | 5.700 | 162,318.75 | 332,318.75 | 494,637.50 |
| 01/01/93 | | | 157,473.75 | 157,473.75 | |
| 07/01/93 | 180,000 | 5.900 | 157,473.75 | 337,473.75 | 494,947.50 |
| 01/01/94 | | | 152,163.75 | 152,163.75 | |
| 07/01/94 | 190,000 | 6.100 | 152,163.75 | 342,163.75 | 494,327.50 |
| 01/01/95 | | | 146,368.75 | 146,368.75 | |
| 07/01/95 | 200,000 | 6.300 | 146,368.75 | 346,368.75 | 492,737.50 |
| 01/01/96 | | | 140,068.75 | 140,068.75 | |
| 07/01/96 | 215,000 | 6.500 | 140,068.75 | 355,068.75 | 495,137.50 |
| 01/01/97 | | | 133,081.25 | 133,081.25 | |
| 07/01/97 | 225,000 | 6.700 | 133,081.25 | 358,081.25 | 491,162.50 |
| 01/01/98 | | | 125,543.75 | 125,543.75 | |
| 07/01/98 | 240,000 | 6.900 | 125,543.75 | 365,543.75 | 491,087.50 |
| 01/01/99 | | | 117,263.75 | 117,263.75 | |
| 07/01/99 | 260,000 | 7.100 | 117,263.75 | 377,263.75 | 494,527.50 |
| 01/01/00 | | | 108,033.75 | 108,033.75 | |
| 07/01/00 | 275,000 | 7.200 | 108,033.75 | 383,033.75 | 491,067.50 |
| 01/01/01 | | | 98,133.75 | 98,133.75 | |
| 07/01/01 | 295,000 | 7.300 | 98,133.75 | 393,133.75 | 491,267.50 |
| 01/01/02 | | | 87,366.25 | 87,366.25 | |
| 07/01/02 | 320,000 | 7.400 | 87,366.25 | 407,366.25 | 494,732.50 |
| 01/01/03 | | | 75,526.25 | 75,526.25 | |
| 07/01/03 | 345,000 | 7.450 | 75,526.25 | 420,526.25 | 496,052.50 |
| 01/01/04 | | | 62,675.00 | 62,675.00 | |
| 07/01/04 | 370,000 | 7.500 | 62,675.00 | 432,675.00 | 495,350.00 |
| 01/01/05 | | | 48,800.00 | 48,800.00 | |
| 07/01/05 | 395,000 | 7.625 | 48,800.00 | 443,800.00 | 492,600.00 |
| 01/01/06 | | | 33,740.63 | 33,740.63 | |
| 07/01/06 | 425,000 | 7.625 | 33,740.63 | 458,740.63 | 492,481.25 |
| 01/01/07 | | | 17,537.50 | 17,537.50 | |
| 07/01/07 | 460,000 | 7.625 | 17,537.50 | 477,537.50 | 495,075.00 |
| TOTAL | 5,160,000 | | 4,710,016.25 | 9,870,016.25 | |
| ACCRUED THRU 07/01/87 | | | 0.00 | 0.00 | |
| NET COST | | | 4,710,016.25 | 9,870,016.25 | |

| | |
|---|---|
| AVERAGE COUPON | 7.243 |
| BOND YEARS | 65,025.000 |
| AVERAGE LIFE | 12.602 |

A. H. Williams & Co.

## LOCAL SCHOOL DISTRICT GENERAL OBLIGATION
## $5,000,000 PROJECT COST
## 20 YEAR BOND ISSUE
## SOURCES AND USES OF FUNDS

| ESTIMATED SOURCES OF FUNDS | |
|---|---|
| Bond Proceeds | $5,195,000.00 |
| | $5,195,000.00 |

| ESTIMATED USES OF FUNDS | |
|---|---|
| Construction | $5,000,000.00 |
| Insurance Premium | 63,452.94 |
| Issuance Costs | 48,427.06 |
| Underwriter's Discount | 83,120.00 |
| | $5,195,000.00 |

## LOCAL SCHOOL DISTRICT GENERAL OBLIGATION
## $5,000,000 PROJECT COST
## 20 YEAR BOND ISSUE
## ESTIMATED ISSUANCE COSTS

| | |
|---|---|
| Bond Counsel | $25,000.00 |
| Local Solicitor | 10,000.00 |
| Initial Trustee Fees | 2,500.00 |
| Printing | 7,000.00 |
| Miscellaneous | 3,927.06 |
| TOTAL | $48,427.06 |

### LOCAL SCHOOL DISTRICT GENERAL OBLIGATION
### $5,000,000 PROJECT
### 20 YEAR INSURED ISSUE

DEBT SERVICE FROM 07/01/87

| DATE | PRINCIPAL | RATE | INTEREST | TOTAL P+I | ANNUAL D/S |
|---|---|---|---|---|---|
| 01/01/88 | | | 173,270.00 | 173,270.00 | |
| 07/01/88 | 140,000 | 4.200 | 173,270.00 | 313,270.00 | 486,540.00 |
| 01/01/89 | | | 170,330.00 | 170,330.00 | |
| 07/01/89 | 150,000 | 4.950 | 170,330.00 | 320,330.00 | 490,660.00 |
| 01/01/90 | | | 166,617.50 | 166,617.50 | |
| 07/01/90 | 155,000 | 5.200 | 166,617.50 | 321,617.50 | 488,235.00 |
| 01/01/91 | | | 162,587.50 | 162,587.50 | |
| 07/01/91 | 165,000 | 5.450 | 162,587.50 | 327,587.50 | 490,175.00 |
| 01/01/92 | | | 158,091.25 | 158,091.25 | |
| 07/01/92 | 170,000 | 5.650 | 158,091.25 | 328,091.25 | 486,182.50 |
| 01/01/93 | | | 153,288.75 | 153,288.75 | |
| 07/01/93 | 180,000 | 5.850 | 153,288.75 | 333,288.75 | 486,577.50 |
| 01/01/94 | | | 148,023.75 | 148,023.75 | |
| 07/01/94 | 190,000 | 6.050 | 148,023.75 | 338,023.75 | 486,047.50 |
| 01/01/95 | | | 142,276.25 | 142,276.25 | |
| 07/01/95 | 205,000 | 6.250 | 142,276.25 | 347,276.25 | 489,552.50 |
| 01/01/96 | | | 135,870.00 | 135,870.00 | |
| 07/01/96 | 215,000 | 6.450 | 135,870.00 | 350,870.00 | 486,740.00 |
| 01/01/97 | | | 128,936.25 | 128,936.25 | |
| 07/01/97 | 230,000 | 6.650 | 128,936.25 | 358,936.25 | 487,872.50 |
| 01/01/98 | | | 121,288.75 | 121,288.75 | |
| 07/01/98 | 245,000 | 6.750 | 121,288.75 | 366,288.75 | 487,577.50 |
| 01/01/99 | | | 113,020.00 | 113,020.00 | |
| 07/01/99 | 260,000 | 6.850 | 113,020.00 | 373,020.00 | 486,040.00 |
| 01/01/00 | | | 104,115.00 | 104,115.00 | |
| 07/01/00 | 280,000 | 6.950 | 104,115.00 | 384,115.00 | 488,230.00 |
| 01/01/01 | | | 94,385.00 | 94,385.00 | |
| 07/01/01 | 300,000 | 7.050 | 94,385.00 | 394,385.00 | 488,770.00 |
| 01/01/02 | | | 83,810.00 | 83,810.00 | |
| 07/01/02 | 320,000 | 7.150 | 83,810.00 | 403,810.00 | 487,620.00 |
| 01/01/03 | | | 72,370.00 | 72,370.00 | |
| 07/01/03 | 345,000 | 7.200 | 72,370.00 | 417,370.00 | 489,740.00 |
| 01/01/04 | | | 59,950.00 | 59,950.00 | |
| 07/01/04 | 370,000 | 7.250 | 59,950.00 | 429,950.00 | 489,900.00 |
| 01/01/05 | | | 46,537.50 | 46,537.50 | |
| 07/01/05 | 395,000 | 7.300 | 46,537.50 | 441,537.50 | 488,075.00 |
| 01/01/06 | | | 32,120.00 | 32,120.00 | |
| 07/01/06 | 425,000 | 7.300 | 32,120.00 | 457,120.00 | 489,240.00 |
| 01/01/07 | | | 16,607.50 | 16,607.50 | |
| 07/01/07 | 455,000 | 7.300 | 16,607.50 | 471,607.50 | 488,215.00 |
| TOTAL | 5,195,000 | | 4,566,990.00 | 9,761,990.00 | |
| ACCRUED THRU 07/01/87 | | | 0.00 | 0.00 | |
| NET COST | | | 4,566,990.00 | 9,761,990.00 | |

| | |
|---|---|
| AVERAGE COUPON | 6.999 |
| BOND YEARS | 65,250.000 |
| AVERAGE LIFE | 12.560 |

A. H. Williams & Co.

## STATE PUBLIC SCHOOL BUILDING AUTHORITY
(Commonwealth of Pennsylvania)

$5,000,000 PROJECT COST

20 YEAR BOND ISSUE WITH BANK QUALIFICATION

### SOURCES AND USES OF FUNDS

| ESTIMATED SOURCES OF FUNDS | |
|---|---|
| Bond Proceeds | $5,160,000.00 |
| | $5,160,000.00 |

| ESTIMATED USES OF FUNDS | |
|---|---|
| Construction | $5,000,000.00 |
| Insurance Premium | 63,028.86 |
| Issuance Costs | 24,731.14 |
| Underwriter's Discount | 72,240.00 |
| | $5,160,000.00 |

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## STATE PUBLIC SCHOOL BUILDING AUTHORITY
(Commonwealth of Pennsylvania)

$5,000,000 PROJECT COST

20 YEAR BOND ISSUE WITH BANK QUALIFICATION

### ESTIMATED ISSUANCE COSTS

| | |
|---|---|
| Bond Counsel | $15,000.00 |
| Initial Trustee Fees | 3,000.00 |
| Printing | 5,000.00 |
| Miscellaneous | 1,731.14 |
| TOTAL | $24,731.14 |

### STATE PUBLIC SCHOOL BUILDING AUTHORITY
### (Commonwealth of Pennsylvania)
### $5,000,000 PROJECT
### 20 YEAR INSURED ISSUE WITH BANK QUALIFICATION

DEBT SERVICE FROM 07/01/87

| DATE | PRINCIPAL | RATE | INTEREST | TOTAL P+I | ANNUAL D/S |
|---|---|---|---|---|---|
| 01/01/88 | | | 172,127.50 | 172,127.50 | |
| 07/01/88 | 140,000 | 4.200 | 172,127.50 | 312,127.50 | 484,255.00 |
| 01/01/89 | | | 169,187.50 | 169,187.50 | |
| 07/01/89 | 145,000 | 4.950 | 169,187.50 | 314,187.50 | 483,375.00 |
| 01/01/90 | | | 165,598.75 | 165,598.75 | |
| 07/01/90 | 155,000 | 5.200 | 165,598.75 | 320,598.75 | 486,197.50 |
| 01/01/91 | | | 161,568.75 | 161,568.75 | |
| 07/01/91 | 160,000 | 5.450 | 161,568.75 | 321,568.75 | 483,137.50 |
| 01/01/92 | | | 157,208.75 | 157,208.75 | |
| 07/01/92 | 170,000 | 5.650 | 157,208.75 | 327,208.75 | 484,417.50 |
| 01/01/93 | | | 152,406.25 | 152,406.25 | |
| 07/01/93 | 180,000 | 5.850 | 152,406.25 | 332,406.25 | 484,812.50 |
| 01/01/94 | | | 147,141.25 | 147,141.25 | |
| 07/01/94 | 190,000 | 6.050 | 147,141.25 | 337,141.25 | 484,282.50 |
| 01/01/95 | | | 141,393.75 | 141,393.75 | |
| 07/01/95 | 200,000 | 6.250 | 141,393.75 | 341,393.75 | 482,787.50 |
| 01/01/96 | | | 135,143.75 | 135,143.75 | |
| 07/01/96 | 215,000 | 6.450 | 135,143.75 | 350,143.75 | 485,287.50 |
| 01/01/97 | | | 128,210.00 | 128,210.00 | |
| 07/01/97 | 230,000 | 6.650 | 128,210.00 | 358,210.00 | 486,420.00 |
| 01/01/98 | | | 120,562.50 | 120,562.50 | |
| 07/01/98 | 245,000 | 6.750 | 120,562.50 | 365,562.50 | 486,125.00 |
| 01/01/99 | | | 112,293.75 | 112,293.75 | |
| 07/01/99 | 260,000 | 6.850 | 112,293.75 | 372,293.75 | 484,587.50 |
| 01/01/00 | | | 103,388.75 | 103,388.75 | |
| 07/01/00 | 280,000 | 6.950 | 103,388.75 | 383,388.75 | 486,777.50 |
| 01/01/01 | | | 93,658.75 | 93,658.75 | |
| 07/01/01 | 300,000 | 7.050 | 93,658.75 | 393,658.75 | 487,317.50 |
| 01/01/02 | | | 83,083.75 | 83,083.75 | |
| 07/01/02 | 320,000 | 7.150 | 83,083.75 | 403,083.75 | 486,167.50 |
| 01/01/03 | | | 71,643.75 | 71,643.75 | |
| 07/01/03 | 340,000 | 7.200 | 71,643.75 | 411,643.75 | 483,287.50 |
| 01/01/04 | | | 59,403.75 | 59,403.75 | |
| 07/01/04 | 365,000 | 7.250 | 59,403.75 | 424,403.75 | 483,807.50 |
| 01/01/05 | | | 46,172.50 | 46,172.50 | |
| 07/01/05 | 395,000 | 7.300 | 46,172.50 | 441,172.50 | 487,345.00 |
| 01/01/06 | | | 31,755.00 | 31,755.00 | |
| 07/01/06 | 420,000 | 7.300 | 31,755.00 | 451,755.00 | 483,510.00 |
| 01/01/07 | | | 16,425.00 | 16,425.00 | |
| 07/01/07 | 450,000 | 7.300 | 16,425.00 | 466,425.00 | 482,850.00 |
| TOTAL | 5,160,000 | | 4,536,747.50 | 9,696,747.50 | |
| ACCRUED THRU 07/01/87 | | | 0.00 | 0.00 | |
| NET COST | | | 4,536,747.50 | 9,696,747.50 | |

| | |
|---|---|
| AVERAGE COUPON | 6.999 |
| BOND YEARS | 64,820.000 |
| AVERAGE LIFE | 12.562 |

A. H. Williams & Co.

### STATE PUBLIC SCHOOL BUILDING AUTHORITY
### (Commonwealth of Pennsylvania)

### $9,500,000 PROJECT COST

### 20 YEAR BOND ISSUE

### SOURCES AND USES OF FUNDS

| ESTIMATED SOURCES OF FUNDS | |
|---|---|
| Bond Proceeds | $9,790,000.00 |
| | $9,790,000.00 |

| ESTIMATED USES OF FUNDS | |
|---|---|
| Construction | $9,500,000.00 |
| Insurance Premium | 121,680.20 |
| Issuance Costs | 31,259.80 |
| Underwriter's Discount | 137,060.00 |
| | $9,790,000.00 |

### STATE PUBLIC SCHOOL BUILDING AUTHORITY
### (Commonwealth of Pennsylvania)

### $9,500,000 PROJECT COST

### 20 YEAR BOND ISSUE

### ESTIMATED ISSUANCE COSTS

| | |
|---|---|
| Bond Counsel | $20,000.00 |
| Initial Trustee Fees | 6,000.00 |
| Printing | 5,000.00 |
| Miscellaneous | 259.80 |
| TOTAL | $31,259.80 |

# STATE PUBLIC SCHOOL BUILDING AUTHORITY
(Commonwealth of Pennsylvania)
$9,500,000 PROJECT
20 YEAR INSURED ISSUE

DEBT SERVICE FROM 07/01/87

| DATE | PRINCIPAL | RATE | INTEREST | TOTAL P+I | ANNUAL D/S |
|---|---|---|---|---|---|
| 01/01/88 | | | 336,261.88 | 336,261.88 | |
| 07/01/88 | 265,000 | 4.250 | 336,261.88 | 601,261.88 | 937,523.75 |
| 01/01/89 | | | 330,630.63 | 330,630.63 | |
| 07/01/89 | 275,000 | 5.000 | 330,630.63 | 605,630.63 | 936,261.25 |
| 01/01/90 | | | 323,755.63 | 323,755.63 | |
| 07/01/90 | 290,000 | 5.250 | 323,755.63 | 613,755.63 | 937,511.25 |
| 01/01/91 | | | 316,143.13 | 316,143.13 | |
| 07/01/91 | 305,000 | 5.500 | 316,143.13 | 621,143.13 | 937,286.25 |
| 01/01/92 | | | 307,755.63 | 307,755.63 | |
| 07/01/92 | 320,000 | 5.700 | 307,755.63 | 627,755.63 | 935,511.25 |
| 01/01/93 | | | 298,635.63 | 298,635.63 | |
| 07/01/93 | 340,000 | 5.900 | 298,635.63 | 638,635.63 | 937,271.25 |
| 01/01/94 | | | 288,605.63 | 288,605.63 | |
| 07/01/94 | 360,000 | 6.100 | 288,605.63 | 648,605.63 | 937,211.25 |
| 01/01/95 | | | 277,625.63 | 277,625.63 | |
| 07/01/95 | 380,000 | 6.300 | 277,625.63 | 657,625.63 | 935,251.25 |
| 01/01/96 | | | 265,655.63 | 265,655.63 | |
| 07/01/96 | 405,000 | 6.500 | 265,655.63 | 670,655.63 | 936,311.25 |
| 01/01/97 | | | 252,493.13 | 252,493.13 | |
| 07/01/97 | 430,000 | 6.700 | 252,493.13 | 682,493.13 | 934,986.25 |
| 01/01/98 | | | 238,088.13 | 238,088.13 | |
| 07/01/98 | 460,000 | 6.900 | 238,088.13 | 698,088.13 | 936,176.25 |
| 01/01/99 | | | 222,218.13 | 222,218.13 | |
| 07/01/99 | 490,000 | 7.100 | 222,218.13 | 712,218.13 | 934,436.25 |
| 01/01/00 | | | 204,823.13 | 204,823.13 | |
| 07/01/00 | 525,000 | 7.200 | 204,823.13 | 729,823.13 | 934,646.25 |
| 01/01/01 | | | 185,923.13 | 185,923.13 | |
| 07/01/01 | 565,000 | 7.300 | 185,923.13 | 750,923.13 | 936,846.25 |
| 01/01/02 | | | 165,300.63 | 165,300.63 | |
| 07/01/02 | 605,000 | 7.400 | 165,300.63 | 770,300.63 | 935,601.25 |
| 01/01/03 | | | 142,915.63 | 142,915.63 | |
| 07/01/03 | 650,000 | 7.450 | 142,915.63 | 792,915.63 | 935,831.25 |
| 01/01/04 | | | 118,703.13 | 118,703.13 | |
| 07/01/04 | 700,000 | 7.500 | 118,703.13 | 818,703.13 | 937,406.25 |
| 01/01/05 | | | 92,453.13 | 92,453.13 | |
| 07/01/05 | 750,000 | 7.625 | 92,453.13 | 842,453.13 | 934,906.25 |
| 01/01/06 | | | 63,859.38 | 63,859.38 | |
| 07/01/06 | 805,000 | 7.625 | 63,859.38 | 868,859.38 | 932,718.75 |
| 01/01/07 | | | 33,168.75 | 33,168.75 | |
| 07/01/07 | 870,000 | 7.625 | 33,168.75 | 903,168.75 | 936,337.50 |
| TOTAL | 9,790,000 | | 8,930,031.25 | 18,720,031.25 | |
| ACCRUED THRU 07/01/87 | | | 0.00 | 0.00 | |
| NET COST | | | 8,930,031.25 | 18,720,031.25 | |

| | |
|---|---|
| AVERAGE COUPON | 7.243 |
| BOND YEARS | 123,295.000 |
| AVERAGE LIFE | 12.594 |

A. H. Williams & Co.

## LOCAL SCHOOL DISTRICT GENERAL OBLIGATION
## $9,500,000 PROJECT COST
## 20 YEAR BOND ISSUE
## SOURCES AND USES OF FUNDS

| ESTIMATED SOURCES OF FUNDS | |
|---|---|
| Bond Proceeds | $9,830,000.00 |
| | $9,830,000.00 |

| ESTIMATED USES OF FUNDS | |
|---|---|
| Construction | $9,500,000.00 |
| Insurance Premium | 119,970.29 |
| Issuance Costs | 52,749.71 |
| Underwriter's Discount | 157,280.00 |
| | $9,830,000.00 |

## LOCAL SCHOOL DISTRICT GENERAL OBLIGATION
## $9,500,000 PROJECT COST
## 20 YEAR BOND ISSUE
## ESTIMATED ISSUANCE COSTS

| | |
|---|---|
| Bond Counsel | $30,000.00 |
| Local Solicitor | 10,000.00 |
| Initial Trustee Fees | 5,000.00 |
| Printing | 7,000.00 |
| Miscellaneous | 749.71 |
| TOTAL | $52,749.71 |

LOCAL SCHOOL DISTRICT GENERAL OBLIGATION
$9,500,000 PROJECT
20 YEAR INSURED ISSUE

DEBT SERVICE FROM 07/01/87

| DATE | PRINCIPAL | RATE | INTEREST | TOTAL P+I | ANNUAL D/S |
|---|---|---|---|---|---|
| 01/01/88 | | | 327,735.00 | 327,735.00 | |
| 07/01/88 | 270,000 | 4.200 | 327,735.00 | 597,735.00 | 925,470.00 |
| 01/01/89 | | | 322,065.00 | 322,065.00 | |
| 07/01/89 | 280,000 | 4.950 | 322,065.00 | 602,065.00 | 924,130.00 |
| 01/01/90 | | | 315,135.00 | 315,135.00 | |
| 07/01/90 | 295,000 | 5.200 | 315,135.00 | 610,135.00 | 925,270.00 |
| 01/01/91 | | | 307,465.00 | 307,465.00 | |
| 07/01/91 | 310,000 | 5.450 | 307,465.00 | 617,465.00 | 924,930.00 |
| 01/01/92 | | | 299,017.50 | 299,017.50 | |
| 07/01/92 | 325,000 | 5.650 | 299,017.50 | 624,017.50 | 923,035.00 |
| 01/01/93 | | | 289,836.25 | 289,836.25 | |
| 07/01/93 | 345,000 | 5.850 | 289,836.25 | 634,836.25 | 924,672.50 |
| 01/01/94 | | | 279,745.00 | 279,745.00 | |
| 07/01/94 | 365,000 | 6.050 | 279,745.00 | 644,745.00 | 924,490.00 |
| 01/01/95 | | | 268,703.75 | 268,703.75 | |
| 07/01/95 | 385,000 | 6.250 | 268,703.75 | 653,703.75 | 922,407.50 |
| 01/01/96 | | | 256,672.50 | 256,672.50 | |
| 07/01/96 | 410,000 | 6.450 | 256,672.50 | 666,672.50 | 923,345.00 |
| 01/01/97 | | | 243,450.00 | 243,450.00 | |
| 07/01/97 | 435,000 | 6.650 | 243,450.00 | 678,450.00 | 921,900.00 |
| 01/01/98 | | | 228,986.25 | 228,986.25 | |
| 07/01/98 | 465,000 | 6.750 | 228,986.25 | 693,986.25 | 922,972.50 |
| 01/01/99 | | | 213,292.50 | 213,292.50 | |
| 07/01/99 | 495,000 | 6.850 | 213,292.50 | 708,292.50 | 921,585.00 |
| 01/01/00 | | | 196,338.75 | 196,338.75 | |
| 07/01/00 | 530,000 | 6.950 | 196,338.75 | 726,338.75 | 922,677.50 |
| 01/01/01 | | | 177,921.25 | 177,921.25 | |
| 07/01/01 | 565,000 | 7.050 | 177,921.25 | 742,921.25 | 920,842.50 |
| 01/01/02 | | | 158,005.00 | 158,005.00 | |
| 07/01/02 | 605,000 | 7.150 | 158,005.00 | 763,005.00 | 921,010.00 |
| 01/01/03 | | | 136,376.25 | 136,376.25 | |
| 07/01/03 | 650,000 | 7.200 | 136,376.25 | 786,376.25 | 922,752.50 |
| 01/01/04 | | | 112,976.25 | 112,976.25 | |
| 07/01/04 | 695,000 | 7.250 | 112,976.25 | 807,976.25 | 920,952.50 |
| 01/01/05 | | | 87,782.50 | 87,782.50 | |
| 07/01/05 | 745,000 | 7.300 | 87,782.50 | 832,782.50 | 920,565.00 |
| 01/01/06 | | | 60,590.00 | 60,590.00 | |
| 07/01/06 | 800,000 | 7.300 | 60,590.00 | 860,590.00 | 921,180.00 |
| 01/01/07 | | | 31,390.00 | 31,390.00 | |
| 07/01/07 | 860,000 | 7.300 | 31,390.00 | 891,390.00 | 922,780.00 |
| TOTAL | 9,830,000 | | 8,626,967.50 | 18,456,967.50 | |
| ACCRUED THRU 07/01/87 | | | 0.00 | 0.00 | |
| NET COST | | | 8,626,967.50 | 18,456,967.50 | |

| | |
|---|---|
| AVERAGE COUPON | 6.998 |
| BOND YEARS | 123,280.000 |
| AVERAGE LIFE | 12.541 |

A. H. Williams & Co.

## STATE PUBLIC SCHOOL BUILDING AUTHORITY
(Commonwealth of Pennsylvania)

$9,500,000 PROJECT COST

20 YEAR BOND ISSUE WITH BANK QUALIFICATION

SOURCES AND USES OF FUNDS

| ESTIMATED SOURCES OF FUNDS | |
|---|---|
| Bond Proceeds | $9,790,000.00 |
| | $9,790,000.00 |

| ESTIMATED USES OF FUNDS | |
|---|---|
| Construction | $9,500,000.00 |
| Insurance Premium | 119,581.15 |
| Issuance Costs | 33,358.85 |
| Underwriter's Discount | 137,060.00 |
| | $9,790,000.00 |

## STATE PUBLIC SCHOOL BUILDING AUTHORITY
(Commonwealth of Pennsylvania)

$9,500,000 PROJECT COST

20 YEAR BOND ISSUE WITH BANK QUALIFICATION

ESTIMATED ISSUANCE COSTS

| | |
|---|---|
| Bond Counsel | $20,000.00 |
| Initial Trustee Fees | 6,000.00 |
| Printing | 5,000.00 |
| Miscellaneous | 2,358.85 |
| TOTAL | $33,358.85 |

## STATE PUBLIC SCHOOL BUILDING AUTHORITY
## (Commonwealth of Pennsylvania)
## $9,500,000 PROJECT
## 20 YEAR INSURED ISSUE WITH BANK QUALIFICATION

DEBT SERVICE FROM 07/01/87

| DATE | PRINCIPAL | RATE | INTEREST | TOTAL P+I | ANNUAL D/S |
|---|---|---|---|---|---|
| 01/01/88 | | | 326,553.75 | 326,553.75 | |
| 07/01/88 | 265,000 | 4.200 | 326,553.75 | 591,553.75 | 918,107.50 |
| 01/01/89 | | | 320,988.75 | 320,988.75 | |
| 07/01/89 | 280,000 | 4.950 | 320,988.75 | 600,988.75 | 921,977.50 |
| 01/01/90 | | | 314,058.75 | 314,058.75 | |
| 07/01/90 | 290,000 | 5.200 | 314,058.75 | 604,058.75 | 918,117.50 |
| 01/01/91 | | | 306,518.75 | 306,518.75 | |
| 07/01/91 | 305,000 | 5.450 | 306,518.75 | 611,518.75 | 918,037.50 |
| 01/01/92 | | | 298,207.50 | 298,207.50 | |
| 07/01/92 | 325,000 | 5.650 | 298,207.50 | 623,207.50 | 921,415.00 |
| 01/01/93 | | | 289,026.25 | 289,026.25 | |
| 07/01/93 | 340,000 | 5.850 | 289,026.25 | 629,026.25 | 918,052.50 |
| 01/01/94 | | | 279,081.25 | 279,081.25 | |
| 07/01/94 | 360,000 | 6.050 | 279,081.25 | 639,081.25 | 918,162.50 |
| 01/01/95 | | | 268,191.25 | 268,191.25 | |
| 07/01/95 | 385,000 | 6.250 | 268,191.25 | 653,191.25 | 921,382.50 |
| 01/01/96 | | | 256,160.00 | 256,160.00 | |
| 07/01/96 | 405,000 | 6.450 | 256,160.00 | 661,160.00 | 917,320.00 |
| 01/01/97 | | | 243,098.75 | 243,098.75 | |
| 07/01/97 | 435,000 | 6.650 | 243,098.75 | 678,098.75 | 921,197.50 |
| 01/01/98 | | | 228,635.00 | 228,635.00 | |
| 07/01/98 | 460,000 | 6.750 | 228,635.00 | 688,635.00 | 917,270.00 |
| 01/01/99 | | | 213,110.00 | 213,110.00 | |
| 07/01/99 | 495,000 | 6.850 | 213,110.00 | 708,110.00 | 921,220.00 |
| 01/01/00 | | | 196,156.25 | 196,156.25 | |
| 07/01/00 | 530,000 | 6.950 | 196,156.25 | 726,156.25 | 922,312.50 |
| 01/01/01 | | | 177,738.75 | 177,738.75 | |
| 07/01/01 | 565,000 | 7.050 | 177,738.75 | 742,738.75 | 920,477.50 |
| 01/01/02 | | | 157,822.50 | 157,822.50 | |
| 07/01/02 | 605,000 | 7.150 | 157,822.50 | 762,822.50 | 920,645.00 |
| 01/01/03 | | | 136,193.75 | 136,193.75 | |
| 07/01/03 | 650,000 | 7.200 | 136,193.75 | 786,193.75 | 922,387.50 |
| 01/01/04 | | | 112,793.75 | 112,793.75 | |
| 07/01/04 | 695,000 | 7.250 | 112,793.75 | 807,793.75 | 920,587.50 |
| 01/01/05 | | | 87,600.00 | 87,600.00 | |
| 07/01/05 | 745,000 | 7.300 | 87,600.00 | 832,600.00 | 920,200.00 |
| 01/01/06 | | | 60,407.50 | 60,407.50 | |
| 07/01/06 | 800,000 | 7.300 | 60,407.50 | 860,407.50 | 920,815.00 |
| 01/01/07 | | | 31,207.50 | 31,207.50 | |
| 07/01/07 | 855,000 | 7.300 | 31,207.50 | 886,207.50 | 917,415.00 |
| TOTAL | 9,790,000 | | 8,607,100.00 | 18,397,100.00 | |
| ACCRUED THRU 07/01/87 | | | 0.00 | 0.00 | |
| NET COST | | | 8,607,100.00 | 18,397,100.00 | |

| | |
|---|---|
| AVERAGE COUPON | 6.999 |
| BOND YEARS | 122,975.000 |
| AVERAGE LIFE | 12.561 |

A. H. Williams & Co.

One Old Stone Square
Providence, Rhode Island 02903
July 16, 1987

Robert J. Leonard, Esq.
Chief Counsel
Committee on Ways and Means
1102 Longworth House Office Building
Washington, D.C. 20515

Re: Technical Corrections Act of 1987

Dear Mr. Leonard:

In response to your request for comments on the bill, "Technical Corrections Act of 1987", HR 2636/S 1350, I submit the following:

1. Designation of Tax-Exempt Issues for Purposes of Bank Deductibility. Code § 265(b)(3); TRA '86 § 902; TCA '87 § 109(b). TCA '87 § 109(b)(5)(A) appears to permit the issuer of an obligation the proceeds of which will be used to refund currently an outstanding obligation which is not designated under Code § 265(b)(3) as long as the face amount of the issue of which the refunding obligation is a part does not exceed $10,000,000. If the issuer elects to designate such a refunding obligation, the amount so designated counts against the issuer's annual $10,000,000 limitation.

The Joint Committee Staff Description, JCS-15-87, however, states that a refunding obligation cannot be designated unless the refunded obligation was designated, qualified for, and taken into account under the $10 million limitation when issued. Description at 76. Because no obligations issued before 1986 could have been designated, the Description's interpretation would prohibit an issuer from designating any obligation issued to refund pre-1986 obligation.

My primary concern is that these inconsistent provisions be reconciled before the Technical Corrections Act is passed. In addition, I would urge that the proper resolution of the inconsistency would be to follow the approach in the bill rather than that in the Description.

In Rhode Island, municipal issuers* will be the principal beneficiaries of the Code § 265(b)(3) exception for qualified tax-exempt obligations. When borrowing for capital projects, such municipal issuers generally issue short-term notes for a period of time (including rollovers) approximately equal to the acquisition and construction period of the project. The notes typically have maturity of 6 to 18 months. At the end of this period, which is generally not more than three to five years, bonds are issued to refund the notes.

The purpose of the Code § 265(b)(3) exception is to permit issuers who, because of their small volume, do not have adequate access to public investors to continue to sell their obligations to local banks at reasonable interest rates. nothing indicates that merely because an issuer issued a short-term note prior to the enactment of the Tax Reform Act that the issuer therefore has better access to public investors with respect to a subsequent note or bond issue that currently refunds such note. Therefore, the interpretation proposed in the Description is arbitrary and does not further the goal of the exception. Furthermore, any possible abuse is prevented by the requirement proposed in the Technical Corrections Act that designated obligations refunding non-designated obligations must be taken into account under the issuer's annual $10,000,000 limit.

Accordingly, the interpretation proposed in the Description should be rejected, and the Act adopted (if at all) as drafted.

2. Industrial Development Bonds. 1954 Code § 103(b)(6)(N); TCA '87 § 113(c)(12)(A). The reference in TCA '87 § 113(c)(12)(A) to "section 103(b)(6) of the 1986 Code" should be to "section 103(b)(6) of the 1954 Code".

3. Election to Exempt Benefits Accrued as of August 1, 1986 from Excise Tax on Excessive Distributions. Code § 4980A(f)(5) as added by TCA '87 § 111A(g)(4)(A). The reference in Code § 4980A(f)(5) as proposed to be added by TCA § 111A(g)(4)(A) to "this chapter" should probably be a reference to either chapter 1 or subtitle A.

Very truly yours,

Daniel C. Waugh

Daniel C. Waugh

* Although I act as bond counsel for several such issuers, none of them has requested that I comment on their behalf.

Section 903

**MARINE MIDLAND BANK, N.A.**

140 Broadway
New York, New York 10005

GORDON F. MARTIN
Administrative Vice President
and Director of Taxes
(212) 440-1417

July 6, 1987

Mr. Robert Leonard
Chief Counsel
Committee on Ways and Means
House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

S 1350/HR 2636 "Technical Corrections Act of 1987"

Special NOL carryback provision for NOLs of commercial banks attributable to bad debt deductions

Dear Mr. Leonard:

Section 903 of the Tax Reform Act of 1986 amended §172(b) of the Internal Revenue Code to provide that, in general, a net operating loss of a commercial bank would be carried back three years and forward fifteen years as is generally the case with all other taxpayers. Congress's reason for providing such a rule was that the net operating losses of commercial banks should be treated in the same manner as that of all other taxpayers, H. Rep. 99-426, pp.592. See also, General Explanation of the Tax Reform Act of 1986 ("Blue Book") at pp.567.

The bill enacted differed from the House proposal by providing an exception to the general rule of "back 3, forward 15". The exception is that for taxable years beginning before January 1, 1994, an NOL is carried back ten years and forward five years to the extent it is attributable to a bad debt deduction. While the Conference Report does not explain Congress's reason for providing such a exception, the Blue Book states, at pp.567:

> Reasons for Change
>
> The Congress believed that net operating losses incurred by financial institutions, such as commercial banks and thrift institutions, should

> be treated in the same manner as net operating losses incurred by other taxpayers. However, the Congress was aware that the immediate application of such a change to commercial banks in concert with the repeal of the reserve method of computing a deduction for bad debts could have an unnecessarily adverse impact upon the deferred tax accounts that such taxpayers keep for financial and regulatory accounting purposes. Accordingly, the ten year carryback period of prior law is retained for such taxpayers for taxable years beginning before 1994 for the portion of a net operating loss attributable to deductions for bad debts.

While Congress may have intended to fashion an exception which benefits a handful of banks, it may not have fully understood the attendant cost. Such a rule adds unnecessary, unwieldy, and unconscionable administrative complexities not only upon commercial banks who did not lobby for such a rule, but also upon IRS officials who will have to track NOLs from the single year of incurrence along two separate carryback tracts.

The Code does not provide ordering rules where the portion of a 1987 NOL carried back ten years frees credits which may be carried forward to the year in which the balance of the NOL is carried back three years. This is but a hint of the complexity. Indeed, the application of a similarly bifurcated alternative minimum tax net operating loss deduction will doubtlessly result in still further complexity.

Therefore, I respectfully request that taxpayers be allowed to treat an entire net operating loss consistently by electing that the entire net operating loss be carried back three years.

Very truly yours,

Gordon F. Martin
Administrative Vice President
and Director of Taxes

**MCorp**
A Momentum Company

Richard C. Amacher
Senior Vice President and Manager
Taxation

July 9, 1987

Mr. Robert J. Leonard
Committee On Ways and Means
1102 Longworth Building HOB
Washington, DC 20515

Re: Comments of MCorp on H.R. 2636

Dear Mr. Leonard:

On behalf of MCorp, a $20 billion bank holding company located in Dallas, Texas, enclosed are comments on H.R. 2636, the Technical Corrections Act of 1987 relating to the Tax Reform Act of 1986, introduced by Chairman Rostenkowski and Congressman Duncan on June 10, 1987.

As the text of the enclosed comments explains, we feel that an appropriate technical correction for the Act to provide in Sec. 109 is a provision which would allow financially troubled banks to elect to carry bad debt losses back ten years and forward five years, rather than providing that such treatment is mandatory. By so providing, the Tax Reform Act imposes an undue hardship on many financially troubled banks, when it appears that the intent of Congress was to provide relief for banks with large bad debt losses. The hardship stems from the very real possibility that such banks will not be able to solve their financial problems and generate significant amounts of taxable income within the five-year carryover period.

We appreciate the opportunity to comment, and stand willing to provide any further information you may require.

Very truly yours,

Richard C. Amacher

rms
Enclosures

# Comments of MCorp
# On
# H.R. 2636
# The
# Technical Corrections Act of 1987

MCorp is pleased to submit these comments on the Technical Corrections Act of 1987 relating to the Tax Reform Act of 1986. A "relief" provision in the Act actually does more harm than good to many banks which fit the definition of "financially troubled" in Act Sec. 901(c)(3)(B).

Sec. 903(b)(1) of the 1986 Act amends Sec. 172(b)(1) of the Code by adding at the end thereof the following paragraph:

> "(L) Bad Debt Losses of Commercial Banks.--In the case of any bank (as defined in section 585(a)(2)), the portion of the net operating loss for any taxable year beginning after December 31, 1986, and before January 1, 1994, which is attributable to the deduction allowed under section 166(a) shall be a net operating loss carryback to each of the 10 taxable years preceding the taxable year of the loss and a net operating loss carryover to each of the 5 taxable years following the taxable year of such loss.

This is obviously a relief provision for banks that have not as yet experienced losses sufficient to cause their utilization of the special ten-year carryback provisions mandated by the Tax Reform Act of 1969. These provisions were enacted to become effective in 1976 when severe restrictions on bank loan loss reserve deductions were to take effect. In short, Congress wanted to provide special relief to banks which might find themselves in a position where they have severe loan losses which would not receive current tax benefits due to the then existing three-year carryback.

With the enactment of the 1986 bill, Congress demonstrated a change of heart in that the special 10-year relief provision has been retracted and banks are now subject to the same 3-year carryback and 15-year carryover rules as other taxpayers. The "relief" exception to this rule (cited above) has the potential to do unintended harm to may financially troubled banks.

Many banks have felt the effects of the current energy and real estate depression for the past few years, incurring huge economic losses due to its effect on our customers. In addition, many banks have recently booked huge loan loss reserve additions with respect to loans to less developed countries, since many of these loans are on non-performing status. Inability to collect interest on non-performing loans, and loan charge-offs, which have reached unprecedented levels, together are of such magnitude that the resulting tax losses will in all probability greatly exceed many banks' capacity to carry back into the ten-year period. Indeed, we are concerned that, with only a five-year carryforward period, these banks may never be able to deduct the losses for tax purposes. Taxable income in that short a carryforward period may not be sufficient to absorb the current losses carried forward. In short, the "relief" provision cited above provides no substantial relief; but, rather it is detrimental and we must question realization of any future benefit relating to the tax losses.

The problem is magnified in the situation where banks may be considering affiliation with other companies to ameliorate the aforementioned financial difficulties.

The banking industry and its regulators have been attempting to find a solution to the deteriorating capital positions of many of these banks. For example, the Texas Legislature enacted legislation last year authorizing out-of-state banks to own Texas banks. This was an attempt to provide a private sector solution to banking's financial problems. To allow out-of-state ownership is far superior to alternative solutions which include FDIC assistance or even eventual failure and liquidation by that agency.

In the several months since enactment of that legislation, there have been relatively few mergers announced involving the potential use of private capital to revitalize Texas banks. We believe that one reason for the scarcity of similar transactions is the five-year carryover provision coupled with the limitations on net operating loss and tax credit carryover utilization imposed by Sec. 621 of the Tax Reform Act of 1986 amending Sec. 382 of the Code. Those provisions effectively limit annual utilization of these carryovers to an amount equal to a proxy interest rate times the purchase price of the acquired company. Bank carryovers with less than a five-year life at the merger date face a far greater degree of probability of expiration than would those with the fifteen-year life available to companies in other industries. For example, a bank with $500 million in carryovers which sells out for $1 billion when the proxy interest rate is 6% is limited to maximum post-merger loss utilization of $300 million ($60 million per year for five years). A non-bank company with a fifteen-year carryover would have an increased probability of utilization of the entire $500 million. Since prospective acquirors look to future after-tax earnings of potential acquirees to determine the economic value of entering into a transaction, it is obvious that limiting troubled banks to a five-year carryover is an impediment to finding a solution in the private sector. In our discussions with investment bankers and CPA's, we have come to the conclusion that little, if any consideration is given by potential acquirors to the possibility that these carryovers will ever be utilized.

Section 901(c) of the 1986 Act, which deals with elimination of bank bad debt reserves, calls for the recapture of existing reserves over a four-year period. But Congress, in recognition of the fact that some banks were facing troubled times, provided another "relief" provision in Sec. 901(c)(3)(B) for "financially troubled banks." Such banks are those whose ratio of non-performing loans to shareholders' equity exceed 75%. Such banks are able to delay reserve recapture until that ratio drops below 75%. Although this relief provision was meant to help the affected banks, it is doubtful that many of them will opt to take advantage of the ability to delay recapture, since their current tax is zero with or without recapture, and delaying recapture would only increase net operating loss carryforwards which expire in five years. To the contrary, such banks would opt to recapture all of the reserve as quickly as possible, so as to minimize those carryovers which may expire before utilization.

Given the desire of Congress to provide relief for troubled banks, as evidenced by the provisions cited above, and the lack of relief or even detrimental effect of these same provisions, we suggest the following be incorporated in the Technical Corrections Act.

Make the above cited provision (Act Sec. 903(b)(1)) elective for financially troubled banks. Let those banks which truly need relief select the carryback/carryforward configuration best suited to their own individual situation. Let those banks which receive no benefit from the 10-year carryback "relief" provision nor from the bad debt recapture "relief" provision have the flexibility to achieve relief in this instance. This could be accomplished by adding a sentence to paragraph (L) of Code Sec. 172(b)(1) cited above which states:

> "Use of this provision shall be elective with respect to those banks described in Sec 585 (c)(3)(B)(iii)."

This provision should have no revenue cost in the five-year window period, since the banks already have a five-year carryforward.

This is an opportunity for Congress to provide genuine economic relief for financially troubled banks. We would be grateful for your support, and welcome the opportunity to discuss this further with Congressional staff.

Title X, Section 1011

Ætna

Financial Division
CityPlace
Hartford, CT 06156

Francis X. Smith
Vice President
Taxes and Accounting Policy
(203) 275-2878

July 17, 1987

Robert J. Leonard
Chief Counsel
Committee on Ways and Means
U.S. House of Representatives
[illegible] Longworth House Office Building
Washington, D.C. 20515

RE: COMMENTS ON TECHNICAL CORRECTIONS BILL
TRANSITION RULE FOR MARKET DISCOUNT BONDS

Dear Mr. Leonard:

Section 110 of H.R. 2636 provides that capital gains on "market discount bonds" held by certain life insurance companies will be taxed at a rate of 31.6%. Section 110 "corrects" the 1986 Tax Reform Act, making two changes in the transition rule provided by that Act: (1) coverage is expanded from the original 15 companies to all life insurance companies, and (2) the tax rate is increased from 28% to 31.6%.

Ætna supports the written comments submitted by the American Council of Life Insurance in urging a generic 29.1% rate. Simply put, the cost of a 29.1% generic rate equals the cost of the original 15 company transition rule. Therefore, changing the tax rate to 29.1% (instead of 31.6%) will not change the government's budget, as reflected in the February baseline.

For Ætna, Section 110's rate increase from 28% to 31.6% represents a significant cost. The company has relied on prior congressional policy, first established in the 1984 Act, to grant transitional tax relief for market discount bonds. Investment returns from these bonds are reflected in the interest rates that Ætna has guaranteed to its customers. The company cannot now recover from these customers any increase in the tax costs of these bonds.

While a 29.1% rate does not fully restore the relief provided by the original transitional rule, the ACLI proposal is equitable and provides much of the original, intended relief. Accordingly, the Committee should adopt the proposal.

Sincerely,

Francis X. Smith
Vice President
Taxes and Accounting Policy

BEST AVAILABLE COPY

John Hancock Mutual Life Insurance Company

Office of the Secretary

John Hancock Place
Post Office Box 111
Boston, Massachusetts 02117

Raeburn B. Hathaway, Jr.
Senior Vice President and Secretary

July 15, 1987

Robert J. Leonard, Esquire
Chief Counsel
Committee on Ways and Means
1102 Longworth House Office Building
Washington, D.C. 20515

Re: Comment on Technical Corrections Bill --
Transition Rule for Market Discount Bonds
Tax Reform Act 1011(d); H.R. 2636 §110

Dear Mr. Leonard:

Section 110 of H.R. 2636 would take away 60 percent of the transitional relief granted to 15 named life insurance companies from the repeal of corporate capital gains in the Tax Reform Act. This amendment to eliminate most of the transitional relief is particularly unfair and certainly constitutes a substantive change in the law. This is clearly contrary to the purpose of the technical corrections bill as stated by Chairman Rostenkowski and Chairman Bentsen. Full transition relief is well justified.

Transitional relief was granted for the market discount on certain bonds that had previously been grandfathered in the 1984 Deficit Reduction Act. This transitional relief is vitally important to these companies because grandfathered market discount bonds have been used by the companies to fund guaranteed investment contracts, which call for the payment of a fixed amount by the companies on a date certain. The companies relied on the tax treatment of grandfathered market discount bonds at time of purchase in establishing the guaranteed rates of interest paid under these contracts. The companies cannot recover any increase in the tax cost of the bonds because the return to the policyholder on the guaranteed investment contracts is fixed. Therefore, unless the transitional relief is substantially retained, these companies will incur significant and unrecoverable damage.

We wish to make it clear that we do not oppose an amendment to provide transitional relief for the rest to the industry. But it is unfair to make the named companies bear the cost by taking away most of their well-deserved transitional relief.

The Joint Committee staff has reestimated the cost of full transitional relief and found it to be less than one-half of what was originally projected. Indeed, we understand that, based on the revenue cost of $120M originally estimated for the named companies, generic transitional relief can be provided to the entire life insurance industry at a rate close to the former corporate capital gains rate. We also note that the technical corrections provision to make generic the capital cost recovery transition rule for aircraft manufacturers in certain states [H.R. 2636 §102(d) (12)] does not similarly reduce the level of relief of those manufacturers under the Tax Reform Act provision.

Therefore, we strongly urge that the Committee retain substantially the tax rate of 28% as the transitional relief for the market discount bond income covered by section 1011(d) of the Tax Reform Act, for generic application of the section.

If you have any questions on this matter or if you desire more information, please contact me at once.

Sincerely,

Raeburn B. Hathaway, Jr.
Senior Vice President and
Secretary

Congreſs of the United States
House of Representatives
Washington, DC 20515

July 14, 1987

The Honorable Dan Rostenkowski
Chairman, Committee on Ways and Means
1100 Longworth House Office Building
Washington, D.C. 20515

Dear Mr. Chairman:

This responds to your request for additional comments on the Technical Corrections Act of 1987. In that bill, the transition rule for gain realized at maturity on market discount bonds that was adopted for certain named life insurance companies in the Tax Reform Act of 1986, is extended to cover the entire life insurance industry. In so extending that rule, the amount of relief granted to the previously identified life insurance companies was significantly reduced; the applicable tax rate was raised from 28% to 31.6%.

While an industry-wide rule is by far preferable, it is important that the rate that was originally applied to the previously named life insurance companies not be raised substantially. Those insurance companies not only relied on the grandfather clause in the Deficit Reduction Act of 1984 when they made their initial investment, but also relied on the transition rule, as enacted, by not selling bonds in 1986 that they otherwise would have sold. What is needed is a way to make the capital gains transition rule applicable to the entire life insurance industry without harming those in the industry that previously were granted relief.

There is an approach that could allow us to substantially restore all the previously intended relief without any formal cost to the budget baseline. When the relief of 28% rate was granted to the named insurance companies, the anticipated budget cost was approximately $120 million. If that amount could be used for the broader rule, the applicable tax rate would be 29.1%. This would in large measure restore the relief that was originally given to the named companies as well as be equitable for the rest of the life insurance industry.

I hope that you and your staff will give this matter consideration. For your convenience, enclosed is some background material of this issue.

Very truly yours,

Robert T. Matsui
Frank J. Guarini

Harold Ford

Ronnie G. Flippo
Ed Jenkins

Barbara B. Kennelly
Beryl Anthony, Jr.

John J. Duncan
Bill Gradison

Bill Frenzel
Byron L. Dorgan

## PROPOSED GENERIC CAPITAL GAINS GRANDFATHER CLAUSE FOR MARKET DISCOUNT BONDS HELD BY LIFE INSURANCE COMPANIES

Summary of Proposal: The capital gains grandfather clause for certain market discount bonds in the Tax Reform Act of 1986 should be expanded to cover all life insurance companies instead of only a limited group of 15 companies. Based on current revenue estimates, such generic treatment would cost $146 million over the next five years. Thus, the proposed change would give uniform treatment to all similarly situated companies while adhering closely to the $120 million which Congress allocated for transitional relief for capital gains attributable to market discount bonds held by life insurance companies.

Background: The Tax Reform Act of 1986 repealed the corporate capital gains tax rate of 28% and subjected such gains to tax at the new 34% corporate ordinary income tax rate.

However, as part of its transitional rules, Congress decided to allocate amounts to a grandfather clause with respect to the capital gains tax rate for market discount on existing bond portfolios held by life insurance companies (and previously grandfathered under the 1984 legislation). At the time this transitional relief was being considered last fall, it was estimated that the revenue cost of a full grandfather clause (i.e., one preserving the prior 28% tax rate) for all life insurance companies would significantly exceed the amount that could be allocated to this relief. Thus, it was decided to enact a 28% provision applicable to only 15 life insurance companies, based on revenue data indicating that the cost of relief for those companies would equal $120 million over the 5-year revenue estimating period. (Section 1011(d) of the Tax Reform Act of 1986)

The revenue estimates used in connection with the grandfather provision were, of necessity, made very quickly and based on information hurriedly compiled by a limited number of life insurance companies. In order to update the revenue figures to reflect bond sales at the end of the year and make them as accurate as possible, the ACLI, early in 1987, conducted a special survey of member companies requesting information as to market discount in bond portfolios held on December 31, 1986. The results of this survey were given to the staff of the Joint Committee on Taxation. On the basis of this updated information and its own analysis, the Joint Committee staff now estimates that generic transitional relief at a 28% rate would result in a revenue loss of $146 million for the relevant 5-year estimating period. This revised estimate is only $26 million more than the amount Congress originally agreed to spend on this issue.

**Position:** On the basis of this updated information, the market discount transitional relief provided by the 1986 Tax Reform Act can and should be corrected to apply on an industry-wide basis at a 28% rate. Such transitional relief is important. The gain to be realized on a market discount bond is known and fixed at the time of purchase. The after-tax value of that gain is, in turn, often used by life insurance companies in setting investment returns or in pricing contracts it enters into with customers. A grandfather provision is needed to protect existing market discount bonds from a change in the tax rate which could retroactively turn good business decisions into bad decisions.

Moreover, it would be consistent with the revenue allocation in the 1986 Act to expand the transitional relief to the industry as a whole. As indicated, Congress originally agreed to allocate $120 million of capital gains transitional relief to market discount bonds of life insurance companies. Based on current data, the relief provided by the provision in the 1986 Act falls far short of this amount, while the proposed generic provision only slightly exceeds the $120 million figure. The small additional cost (about $5 million per year over the 5-year estimating period) is clearly justified to place all insurance companies on an equal footing.

The Joint Committee Staff estimate of $146 million is made up of two components: $59 million is attributable to maintaining the current 15-company provision and $87 million is attributable to expanding the grandfather clause to apply to the remainder of the life insurance business. It has been suggested by the Staff that, to achieve revenue neutrality, the total revenue cost of a generic rule must be limited to $59 million, the current estimate of the cost for the 15 companies. According to the Staff, this could be accomplished by a partial generic grandfather clause (i.e., at a tax rate of 31.6%, instead of 28%).

Such partial relief would be inconsistent with the Congressional decision to allocate $120 million to transitional relief for market discount bonds. It would effectively grant only one half of that amount of transitional relief ($59 million, instead of $120 million). This large reduction in the scope of the relief would occur because of the inherent difficulties in making estimates of revenues hurriedly and which accurately reflect bond transactions at year end.

# Statement of the Mutual Benefit Life Insurance Company to the Committee on Ways and Means of the United States House of Representatives concerning the Proposed Technical Corrections Act of 1987 (HR 2636)

The Mutual Benefit Life Insurance Company appreciates this opportunity to submit comments to the Committee on Ways and Means respecting the increase in the capital gains tax rate on its pre-1984 Act market discount bonds from 28% to 31.6% under the proposed Technical Corrections Act of 1987. The provision appears as Section 110 (a)(2) of Title I of the bill (HR 2636). Capital gains treatment for discounts on bonds was eliminated by the 1984 Tax Reform Act for bonds issued after July 18, 1984. Therefore, the bonds with which we are here concerned are those that Congress grandfathered under the 1984 Act.

Because Mutual Benefit Life had made contractural commitments to certain holders of large annuity contracts based on the applicability of a 28% capital gains rate to our pre 1984 Act bonds, we had a serious problem with the increase in the corporate capital gains rate under the 1986 Act if it were made applicable to them. Accordingly, we worked very hard while Congress was considering the 1986 legislation to continue capital gains treatment at a 28% rate for these bonds on a generic basis, that is for all life companies holding these bonds. Unfortunately, the high cost of generic relief estimated by the Joint Committee (between $300 and $450 million) made a generic rule at 28% too costly. As a result relief at 28% was provided under the 1986 Act only for fifteen companies, including Mutual Benefit Life, that had been particularly active on this issue during the legislative process. The transition relief provided was estimated at the time to have a cost of approximately $120 million. In reliance on this provision of the 1986 Act, Mutual Benefit continued to hold the bonds in question.

Under the proposed Technical Corrections Act of 1987 this provision is expanded to apply to all life insurance companies, however, the applicable tax rate is increased from 28% to 31.6% While we continue to agree that there should be generic rule we are very much opposed to the 3.6% increase in the rate from 28% to 31.6% as being both unfair and unnecessary.

We currently are holding bonds purchased at market discount on which we will realize $834 million of taxable capital gains. ($160 million of this gain will be realized in the 1986-90 period). The 3.6% differential between the 28% corporate capital gains rate under the 15 company transition rule and the generic 31.6% rate in the Technical Corrections Act of 1987 will cost Mutual Benefit $30.1 million in additional taxes ($5.76 million in the 1986-90 period). Again, while we support a generic transition rule, the increase in our taxes which will be generated by the rate increase in the Technical Corrections Act of 1987 makes this provision more than a mere technical correction to us. Moreover, it will also have an adverse effect on the profitability of the annuity business supported by these bonds.

We understand that the Joint Committee has assigned a revenue estimate of $146 million to a 28% generic discount bond transition rule. This compares favorably with the revenue estimate of $120 million assigned to the 15 company transition rule when it was adopted. The 31.6% rate in the proposed Technical Corrections Act of 1987 is apparently based on a new revenue estimate for the 15 company transition rule of $59 million. In other words the results of the effort to achieve a revenue neutral generic transition rule by showing that the original revenue estimates were too high have been misapplied in the proposed Act and the revised 59 million revenue estimate for the 15 company rule has been used to arrive at the 31.6% rate. It is submitted that a truly revenue neutral generic transition rule should have a revenue cost of the original $120 million which Congress agreed to spend on this issue. We understand that a 29.1% generic rate would cost $120 million and therefore be revenue neutral on this basis. If Congress now only spends $59 million to obtain a generic rule then it will be generating $60 million in additional revenue by reneging on its promise of 28% relief to companies such as Mutual Benefit. Basic fairness would seem to require that at least $120 million be spent on a generic discount bond transition rule to avoid imposing unnecessary hardship on companies such as Mutual Benefit Life who were active on this issue in connection with the 1986 Act and who therefore relied on the current 28% transition rule in continuing to hold these bonds after the 1986 Act's increase in the corporate capital gains rate became effective.

In summary while we support a generic transition rule we are very much opposed to the unnecessary and unfair increase in the tax rate. We believe that fairness dictates that the new revenue estimates be used to achieve a 29.1% generic transition rule rather than to provide additional revenue to the government.

## STATEMENT SUBMITTED ON BEHALF OF PROVIDENT LIFE AND ACCIDENT INSURANCE COMPANY ON THE TECHNICAL CORRECTIONS ACT OF 1987

### Transition Rule for Market Discount Bonds

[Tax Reform Act §1011(d); H.R. 2636 §110]

Section 110 of H.R. 2636 would take away 60 percent of the transitional relief granted to 15 named life insurance companies from the repeal of the alternative corporate capital gains rate in section 1011(d) of the Tax Reform Act of 1986. This proposed amendment to eliminate most of that transitional relief is particularly unfair and certainly constitutes a substantive change in the law, contrary to the express purpose of the technical corrections bill as stated by Chairmen Rostenkowski and Bentsen. Full transition relief should be retained.

Transitional relief was granted for the market discount on certain bonds that had previously been grandfathered in the 1984 Act. This transitional relief is vitally important to these life insurance companies because grandfathered market discount bonds have been used by the companies to fund guaranteed investment contracts, which call for the payment of a fixed amount by the companies on a date certain. The companies relied on the tax treatment of grandfathered market discount bonds in establishing the guaranteed rates of interest paid under these contracts, and the companies cannot recover any increase in the tax cost of the bonds because the return on the guaranteed investment contracts is fixed. Therefore, unless full transitional relief is retained, these companies will incur significant and unrecoverable damage.

We wish to make it clear that we do not oppose an amendment to provide transitional relief for the rest of the life insurance industry. But it is unfair to make the named companies bear the cost by taking away most of their transitional relief.

The Joint Committee staff has reestimated the cost of full transitional relief and found it to be less than one-half of the amount originally projected. Indeed, we understand that, based on the revenue cost of $120 million originally estimated for the named companies, generic transitional relief can be provided to the entire life insurance industry at a rate close to the former alternative corporate capital gains rate. We also note that the proposed technical corrections provision to make generic the capital cost recovery transition rule for aircraft manufacturers in certain states [H.R. 2636 §102(d)(12)] does not similarly reduce the level of relief of manufacturers under the Tax Reform Act provision.

Therefore, we strongly urge the Committee retain substantially the tax rate of 28 percent as the transitional relief for market discount bond income covered by section 1011(d) of the Tax Reform Act for generic application of the section.

### Supplemental Information

This statement is submitted by John E. Chapoton and Thomas A. Stout, Jr. of VINSON & ELKINS, 1455 Pennsylvania Avenue, N.W., Washington, D.C. 20004-1007, telephone no. (202) 639-6500, on behalf of PROVIDENT LIFE AND ACCIDENT INSURANCE CO.

July 17, 1987

Section 1012

AMERICAN BAR ASSOCIATION
**The ABA Fund for Justice and Education**
750 North Lake Shore Drive
Chicago, Illinois 60611
(312) 988-5400
ABA/net: ABA163

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June 29, 1987

I am writing to you with a request of utmost importance. My colleagues and I in the development and fundraising profession are concerned about the recent bill introduced and known as the Technical Corrections Act of 1987 (H.R. 2636). It is my personal hope that you will play a role in seeing that this bill is amended before its enactment to protect the long-range future of many necessary and useful charities.

What I am requesting specifically is that you and your colleagues associated with the House Ways and Means Committee see that the aforementioned bill be amended to ensure that charitable gift annuities are not subject to IRC Sec. 501(m). As this section of the code now reads, it could be misinterpreted and allow for the treatment of gift annuities as "commercial-type insurance." This would cause charities to be taxed as insurance companies on the annuity programs and, in some cases, place organizations in risk of losing their tax exempt status.

I know that the consequences I indicate above are not the intent of the bill but our advisors inform us that this may happen regardless of intent. For many decades charitable organizations have used gift annuities to support public service programs. These gift giving arrangements are used because the donor wants to help a worthy organization. It is a fact that other investments may be more profitable but the primary goal of the donor (despite the creation of some income) is to strengthen non-profit organizations.

It is clear that a gift annuity program does not pose a threat to commercial annuities or insurance programs and for many charitable organizations is a vital part of a healthy future.

I ask you as a private citizen and in my capacity as a development officer for the American Bar Association Fund for Justice and Education to do what you can to amend this bill.

Thank you for your consideration and attention to this matter.

Sincerely,

Chuck Coughlin
Director, Planned Giving

The American Lutheran Church
*Office of the Foundation*

422 South Fifth Street
Minneapolis, Minnesota 55415
612-330-3100

June 25, 1987

Members of Congress
Committee on Ways and Means
1102 Longworth House Office Building
Washington, D.C. 20515

Dear Committee Members:

Please amend the Technical Corrections Act of 1987 (H.R. 2636) to clarify that charitable gift annuities issued by IRC Sec.501(c)(3) organizations are not "commercial-type insurance" under IRC Sec.501(m).

The very basic charitable gift structure of the gift annuity agreement represents 60% of the smaller contractual gifts made by our faithful donors....who contribute significantly to the many ministries and services of The American Lutheran Church. These individuals are not in that category of donors who make choices annually about major sums contributed to charity; nonetheless they are motivated contributors.

The format for charitable gift annuities is not that of the commercial-type insurance design for an annuity -- it has never been.

Please do what you can to preserve the charitable and unique status of the Gift Annuity Agreement for our faithful, our donor-oriented development staff people, and for qualified charities throughout this country.

Thank you.

Sincerely,

Carol A. Markuson

Carol A. Markuson
Director

CAM:jt

in abiding love

WILLS
AWARENESS
PROGRAM

LINDY (MRS. HALE) BOGGS, M.C.
2D DISTRICT, LOUISIANA
COMMITTEES:
APPROPRIATIONS
SELECT COMMITTEE ON CHILDREN, YOUTH, AND FAMILIES
(CHAIR, TASK FORCE ON CRISIS INTERVENTION)
PEG KAVALJIAN
ADMINISTRATIVE ASSISTANT

**Congress of the United States**
**House of Representatives**
**Washington, DC 20515**

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WASHINGTON, DC 20515
(202) 225-6636
DISTRICT OFFICE:
1012 HALE BOGGS FEDERAL BUILDING
500 CAMP STREET
NEW ORLEANS, LA 70130
(504) 589-2274

August 15, 1987

The Honorable Dan Rostenkowski
Chairman
Committee on Ways and Means
1101 Longworth Building
Washington, D.C. 20515

Dear Mr. Chairman:

I am sorry to bother you with this request, but the writer of the enclosed letter and the organizations to which he refers are important contributors to so many needs in our state that I felt compelled to "go to the top".

I have received the enclosed correspondence from Dr. Charles W. Heim, President of Ochsner Medical Foundation in New Orleans regarding its concerns about the proposed Technical Corrections Act (H.R. 2636) and the manner in which it addresses Charitable Gift Annuities.

Your advice and guidance in this matter is deeply appreciated.

With my kindest regards.

Sincerely,

Lindy (Mrs. Hale) Boggs, M.C.

ALTON OCHSNER
MEDICAL FOUNDATION
1516 Jefferson Highway
New Orleans, Louisiana 70121
Phone: 504/838-3000
Cable Address: OCHSCLINIC

Ochsner

July 27, 1987

The Honorable Lindy Boggs
2353 Rayburn Building
Washington, DC 20515

Dear Mrs. Boggs:

I urge you to support and vote for the Technical Corrections Act of 1987 (H.R. 2636) with the addition of Sec 501(m) that excludes "Charitable Gift Annuities" under the provisions of that section.

Charitable Gift Annuities do NOT compete with commercial annuities and are NOT commercial-type insurance. A person who uses a Charitable Gift Annuity does so because he wants to make a donation or gift to a particular charity. Unless clarification is made to current law, necessary funds made possible through Charitable Gift Annuities will be eliminated. Thousands of charities, like the Alton Ochsner Medical Foundation, throughout the country will suffer.

Charitable Gift Annuities benefit the charities of those of lesser wealth who want to give. Other "split interest" gifts were affected by TRA '86. Charitable Gift Annuities need to regain the support of Congress.

I know of more than 13 organizations in Louisiana alone which utilize Charitable Gift Annuities as a source of funds to insure their future. Failure to exclude Charitable Gift Annuities as stated in Sec 501(m) will deal a serious blow to these and other charities nationwide.

Your personal assistance and cooperation in preserving the gift annuity as an important gift vehicle for use by donors to Ochsner will be deeply appreciated.

Sincerely,

Charles W. Heim, Jr.
Vice President and
Director, Division of Development

Carnegie
Mellon

**The Campaign for Carnegie Mellon**
Office of Estate Planning
Carnegie Mellon University
5000 Forbes Avenue
Pittsburgh, Pennsylvania 15213-3890
412-268-2017

June 29, 1987

Robert J. Leonard, Chief Counsel
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, DC 20515

To Whom It May Concern:

Re: IRC Section 501(m) and Charitable Gift Annuities

As Director of Estate Planning at Carnegie Mellon University, I am responsible for our planned deferred giving program. An extremely attractive and important component of our program is the Charitable Gift Annuity. The Charitable Gift Annuity appeals particularly to the donor who wants to make a major charitable gift of, for example, $5,000 to $50,000, but financially and personally needs to retain an annual life income or annuity from his or her gift. Our Gift Annuities provide a key source of funding to Carnegie Mellon, which has become all the more important in the face of cutbacks in federal and state aid.

I feel strongly that the taxation of Charitable Gift Annuities under Section 501(m) of the Internal Revenue Code enacted by the Tax Reform Act of 1986 would be extremely detrimental to our long standing gift annuity program, as well as to the programs of other charitable organizations.

Charitable Gift annuities require a clear donative intent as the rate of annuity payout is not competitive with annuities paid by commercial type insurance.

On behalf of Carnegie Mellon University, and as a long time sponsor of the Committee on Gift Annuities, I respectfully request that you and your fellow committee members adopt a specific provision that Charitable Gift annuities are exempt from IRC Section 501(m). Thank you in advance for your support.

Very sincerely,

Gordon Gordon

Gordon Gordon
Director of Estate Planning

FOUNDED [illegible]

THE CHILDREN'S HOSPITAL OF PHILADELPHIA
34th STREET AND CIVIC CENTER BOULEVARD • PHILADELPHIA, PA 19104 • (215) 596-9100

July 6, 1987

The Honorable William J. Coyne
424 Cannon House Office Building
Washington, D. C. 20515-3814

Dear Representative Coyne:

re: Technical Corrections Act of 1987
H.R. 2636

I urge you to amend the above Act to clarify that charitable gift annuities are not commercial-type insurance. Rather, they enable institutions such as ours to continue their ability to provide care to those who need it.

Our Hospital, first in the nation for sick children, conducts a Planned Giving program which enables large and small donors to contribute to our support. You can imagine how important such support is. Last year, we absorbed 11.3 million dollars in free care. In particular, gift annuities do not compete with commercial annuities or commercial-type insurance. Furthermore, there is more than a century of history in this category of giving. In addition, a gift annuity enables smaller donors to make gifts equal in size to a large donor's charitable remainder annuity trust, which is unaffected by IRC Sec. 501(m).

Rising costs of health care combined with cutbacks in payment for the medical services make it more important than ever for the American system of volunteer philanthropy to flourish. Your amending the Technical Corrections Act of 1987 to clarify that charitable gift annuities are not subject to IRC Sec. 501(m) will help assure the future of volunteer not-for-profit organizations.

Sincerely,

Shirley Bonnem
Vice President

Children's Hospital is an equal opportunity employer and patients are accepted without regard to race, creed, color, national origin or sex

JOHN
17:23
THAT THE
WORLD MAY
KNOW

LIFE INCOME GIFTS SERVICES
ROBERT D. HEMPEL, Director

June 22, 1987

The Honorable Robert J. Leonard
Chief Council
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Dear Mr. Leonard:

Those of us here at the Headquarters of the Church of the Nazarene are greatly concerned that Congress take steps to see that the Technical Corrections Act of 1987 (HR 2636) will recognize that gift annuities are not "commercial type insurance" under IRC Section 501(m).

It is difficult to see how charitable gift annuities would be in any competition with commercial type insurance. People with whom we deal have an innate desire to give. Without this desire, they can always get a greater return from the commercial insurance annuity. A charitable gift annuity is acknowledged by the Internal Revenue Service to be part gift and part annuity; this is not the case with insurance annuities.

The small donor is the one most likely to use the gift annuity through our organization. This donor "took his lumps" when the non-itemized charitable deductions were lost. We must not let this same donor lose an opportunity to express his charitable intent through a gift annuity.

Please clarify this law in a manner that will not dry up an important source of funds for our organization's charitable activities. Thank you for exercising your influence in this behalf.

Sincerely,

Robert D. Hempel

Robert D. Hempel
Director

INTERNATIONAL HEADQUARTERS • CHURCH OF THE NAZARENE • FINANCE DIVISION
6401 THE PASEO • KANSAS CITY, MISSOURI 64131

TONY COELHO
15TH DISTRICT, CALIFORNIA
MAJORITY WHIP

COMMITTEE ON AGRICULTURE

COMMITTEE ON INTERIOR AND
INSULAR AFFAIRS

COMMITTEE ON
HOUSE ADMINISTRATION

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House of Representatives
Washington, DC 20515

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WASHINGTON, DC 20515
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(209) 383-4455

900 H STREET, SUITE B
MODESTO, CA 95354
(209) 527-1914

August 18, 1987

Hon. Dan Rostenkowski
Chairman
Committee on Ways and Means
1102 Longworth HOB
Washington, D.C. 20515

Dear Dan:

Attached is a copy of a letter I recently received from Mr. Warren Looker the Director of Planned Giving for Sansum Medical Research Foundation.

I would appreciate your reviewing and responding to Mr. Looker's suggestions regarding gift annuities as they are defined in the proposed corrections to the "commercial-type insurance" provisions of the Technical Corrections Act of 1987.

Your assistance and advice with this matter is appreciated.

Sincerely,

TONY COELHO
MEMBER OF CONGRESS

JUN 29 1987

*Sansum Medical Research Foundation*

2219 BATH STREET • SANTA BARBARA, CALIFORNIA 93105
TELEPHONE (805) 682-7638

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Edmund M. Wroblewski, M.D.

Charles M. Peterson, M.D.
Director of Research
Kenneth R. Edwardsen
Executive Director

June 25, 1987

Dear Congressman Coehlo,

There is an urgent need to have the Technical Corrections Act of 1987 (H.R. 2636) amended to clarify that charitable gift annuities are not subject to IRC Sec. 501(m). It is critically important to draw the distinction that gift annuities are not "commercial-type insurance" under IRC Sec. 501(m).

Our concern is that there could be a misinterpretation under IRC Sec. 501(m) that would result in charitable gift annuities as "commercial type insurance" causing charities to be taxed as insurance companies and thus lose their tax-exempt status altogether.

We respectfully request that the Technical Corrections Act of 1987 (H.R. 2636) be amended to clarify that charitable gift annuities issued by IRC Sec. 501(c)(3) organizations are not "commercial-type insurance" under IRC Sec. 501(m).

We wish to emphasize that many of our donors who select the gift annuity program for their charitable gifts are elderly, living on modest fixed incomes and rely heavily on the present tax advantages. They have a deep interest in providing gifts for medical research programs; failure to clarify the law would dry up an important source of funds for all charities who issue gift annuities.

It seems fair to mention that charitable gift annuities have been used by charitable organizations for over 100 years. For the donor who can make only relatively small gifts, a charitable gift annuity is the equivalent of a charitable remainder annuity trust used by donors of large amounts. The latter "trust" is unaffected by IRC Sec. 501(m).

Please favorably consider this special request on behalf of charitable organizations and institutions and the caring donors who support their humanitarian work.

Respectfully yours,

Warren Looker
Warren Looker
Director of Planned Giving

Congressman Tony Coehlo
Room 403 Cannon Building
House Office Building
Washington, D.C. 20510

Conservative Baptist
National Stewardship Ministries

June 25, 1987

**Harry D. Pittman**
**National Representative**
**2535 E. Cactus Rd.**
**Phoenix, Az. 85032**
**602-971-6188**
**602-992[redacted]**
2022

Robert J. Leonard, Esq., Chief Counsel
Committee on Ways and Means, U.S. House of Representatives
1102 Longworth House Office Building
Washington, DC 20515

RE: IRC Sec. 501(m) - Technical Corrections Act of 1987 (H.R. 2636) Charitable Gift Annuities

Dear Mr. Leonard:

I am writing to you on behalf of our 2,000 churches and over 500,000 constituency in the United States, plus our approximately 2,200 churches and alike constituency outside of the United States regarding the Technical Corrections Act of 1987 (H.R. 2636) requesting that you please support an amendment to the Technical Corrections Act to clarify the position of Charitable Gift Annuities issued by IRC Sec. 501(cX3) organizations that such Charitable Gift Annuities are not "commercial-type insurance" under IRC Sec. 501(m).

As you are aware, many charitable organizations, but especially church denominations, use Gift Annuities because an interested donor wants to make a gift to help our ministry efforts. They are not making the investment in the annuity in order to receive an insurance benefit. Charitable Gift Annuities have been used by church organizations, as well as many other charitable institutions for well over one hundred years. There is a long precedent in our nation's history and tax-law in support of the Charitable Gift Annuity as a charitable gift and not as "commercial-type insurance."

Secondly, Charitable Gift Annuities do not compete with commerical annuities since it costs the donor more to invest in a gift annuity than it does in a commercial annuity, and therefore Charitable Gift Annuities are not "commercial-type insurance."

Thirdly, continuing to classify Charitable Gift Annuities as "commercial-type insurance" fails to clarify the law so that this important source of funds for our denomination's charitable activities would tend to dry up.

Finally, for our small donors, a Charitable Gift Annuity has the same result for them that larger donors' investments in a Charitable Remainder Annuity Trust has for them. As you know, the Charitable Remainder Annuity Trust is unaffected by IRC Sec. 501(m). I trust you will use the weight of your office to see that as the Technical Corrections Act makes it way through the House and Senate Committees and onto the Floor of the respective Houses, we can remove Charitable Gift Annuities from being classified as "commercial-type insurance."

I thank you in advance for your respectful and kind attention to this matter and plead the cause of our denomination in your help in making this correction.

Respectfully,

Harry D. Pittman

Harry D. Pittman, Director
Stewardship Ministries

HDP:vl

Conservative Baptist Association of America P.O. Box 66, Wheaton, Illinois 60187

OF AMERICA

**BEQUESTS & TRUSTS**

*The Planned Giving Program of Dartmouth College*

Blunt Alumni Center Hanover, NH 03755

Frank A. Logan '52, *Director* 603/646-2150
Angus M. Russell '52, *Assoc. Director* 603/646-2260
Charles S. C. Clement '80, *Assoc. Director* 603/646-3450

July 1, 1987

Robert J. Leonard, Chief Counsel
House Committee on Ways and Means
1102 Longworth House Office Building
Washington, DC 20515

Dear Mr. Leonard:

We understand that there is a question as to whether "charitable gift annuities" may be subject to taxation under Section 501(m) of the Internal Revenue Code, as enacted by the Tax Reform Act of 1986. The new 501(m) provision is designed to tax the commercial-type activities of some tax-exempt organizations. In speaking for Dartmouth College, I know I also reflect the view of the entire charitable community in this country in expressing the opinion that the taxation of charitable gift annuities under 501(m) would represent a serious miscarriage of the intent of the new Code section. Let me explain.

It is clear that donors who make gifts to charitable institutions in exchange for gift annuities are motivated by the desire to make a charitable gift, not a financial investment. The annuity rates used by Dartmouth and most other charitable institutions throughout the country are only about one-half the annuity rates available through commercial insurance companies. Even taking into account the fact that a portion of the gift given in exchange for a charitable gift annuity is considered a deductible charitable contribution, the cost to the donor for a gift annuity is not even close to being competitive with the cost for a commercial annuity. Hence, any individual who is solely or primarily seeking the best financial return for himself/herself would purchase a commercial annuity and would never make a charitable gift for a gift annuity.

The reason for the existence of the charitable gift annuity, as for the existence of the various charitable remainder trust plans (unitrust, annuity trust and pooled income funds), is very simply the fact that it permits a donor to benefit a charitable organization in which he/she is interested and wishes to support while retaining a degree of income protection for himself/herself and his/her family. Invariably, donors who make retained-interest charitable gifts feel they simply cannot afford to make such gifts on a purely outright basis.

In essence, for the donor of modest circumstances, the charitable gift annuity is the equivalent of the more affluent donor's annuity trust or unitrust, plans which are not affected by Section 501(m). In fact, most gifts for charitable gift annuities are very modest in size and are almost always made by elderly individuals who by no stretch of the imagination would be considered wealthy or even well-to-do.

Charitable gift annuities have been widely used in the charitable community for more than 100 years and never have they been considered "commercial-type insurance". Nowadays, the gift annuity is almost universally available from thousands of educational and other charitable institutions and organizations across the country as a way of attracting the financial support of interested constituents of modest means. For Dartmouth and for the rest of the charitable community, making the charitable gift annuity subject to taxation under Section 501(m) would eliminate an important method of attracting such support for our educational/charitable activities.

It is our sincere hope that the possibility of Section 501(m) applying to charitable gift annuities was inadvertent and unintentional. For Dartmouth College and, I am sure, for all of the charitable community, we will be most grateful for your support and assistance in assuring that charitable gift annuities will not be subject to such taxation in the General Explanation of the Tax Reform Act of 1986 and/or in the Technical Corrections Bill to the Act.

Sincerely,

Frank A. Logan

FRANK A. LOGAN

ONE HUNDREDTH CONGRESS
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COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES
WASHINGTON, DC 20515

July 20, 1987

The Honorable Dan Rostenkowski
Chairman
Committee on Ways and Means
1102 Longworth HOB
Washington, D.C. 20515

Dear Mr. Chairman:

We are writing to you today concerning a technical problem in the 1986 Tax Reform Act (the "1986 Act") potentially affecting virtually every charitable organization in the country.

Under section 501(m) of the Internal Revenue Code, as added by the 1986 Act, an otherwise tax-exempt organization will be denied exempt status if any substantial part of its activities consists of providing commercial-type insurance. Even if no substantial part of such an organization's activities consists of providing such insurance, the organization will be taxed under unrelated business income rules if it provides any commercial-type insurance. For purposes of these rules, the issuance of annuity contracts is treated as the providing of insurance.

We have been contacted by numerous charitable organizations expressing concern that section 501(m), read literally, could apply to the charitable gift annuities traditionally used by these organizations as part of their planned giving arrangements. We believe it was not the intention of Congress, in enacting section 501(m), to affect charitable gift annuities. Accordingly, we respectfully urge that a technical correction be added to H.R. 2636 (the Technical Corrections Act of 1987) clarifying that section 501(m) of the Internal Revenue Code does not apply to charitable gift annuities.

Sincerely,

John J. Duncan
Bill Archer

Guy Vander Jagt
Bill Frenzel

Bill Gradison
Raymond J. McGrath

Hal Daub
Judd Gregg

Rod Chandler

The First Church of Christ, Scientist
**Office of the Treasurer**

June 29, 1987

The Honorable Dan Rostenkowski
Member, Committee on Ways and Means
Room 2111, Rayburn House Office Building
Washington, D.C. 20515

Re: Section 501(m) of the Internal Revenue Code

Dear Representative Rostenkowski:

The purpose of this letter is to request that you, as a member of the Committee on Ways and Means, consider clarifying the status of Gift Annuity Programs of tax-exempt organizations under §501(m) of the Internal Revenue Code added by §1012 of the Tax Reform Act of 1986. Presumably, such clarification would have to be included in an amendment to the Technical Corrections Act.

Apparently, the intent of Congress in adopting §501(m) was to tax only the commercial-type insurance activities of tax-exempt organizations, including the issuance of annuity contracts. Some commentators indicate that the law is broad enough to cover the issuance of Gift Annuities by such organizations. We question whether that was Congress' intent in view of the nature of Gift Annuities.

As you may know, various tax-exempt organizations administer Gift Annuity Arrangements as a part of their Planned Giving Program. This Church has such an Arrangement whereby a donor transfers cash or securities to the Church and in return receives a lifetime annuity guaranteed by the assets of the Church. It is called a "Gift" Annuity because the rates are designed so as to provide that 50% of the principal transferred to the Church ultimates in a gift to the Church.

This Church does not consider that it is engaged in commercial-type insurance whatsoever but instead feels that it is using a valuable planned giving tool. In fact, in our literature to potential donors, we state that "Since you are making a gift to the Church as well as funding an annuity, the amount of the annuity is not as large as that paid by commercial insurance companies."

THE FIRST CHURCH OF CHRIST, SCIENTIST, CHRISTIAN SCIENCE CENTER, BOSTON, MA, U.S.A. 02115, TELEPHONE (617) 450-2000

We believe that it is important to note that the motivation of the donor is to make a gift, not to obtain an annuity. If the latter reason were predominant, the donor could obtain a much larger annuity from a commercial insurance company.

We understand that gift annuities have been used by charitable organizations for over 100 years. This Church, however, began its Gift Annuity Arrangements in 1972 and has found it a simple method of obtaining contributions, readily understandable by donors and easily administered by the Church. If Gift Annuities were to be held subject to the provisions of §501(m), it would seriously impair our planned giving function as it would add a new complexity to that Program.

If the Church were to eliminate Gift Annuities because of the new administrative burdens imposed by §501(m), the less affluent donor would be restricted in his or her ability to make contributions. The more affluent donors can make use of charitable remainder Unitrusts, Annuity Trusts or Pooled Income Fund Trusts. Because of the intricacies of administering the foregoing types of Arrangements, we have had to place a fairly substantial minimum funding amount on them and, thus, they are not available for the less affluent. The Gift Annuity Arrangement is designed for the non-wealthy donor. It is an anomaly that the Annuity Trust under §664(d)(1), which is somewhat similar to the Gift Annuity, is not affected at all by §501(m) but that the latter arrangement might be.

We sincerely request that you take appropriate action in the Committee to amend the Technical Corrections Act to provide that Gift Annuity Arrangements are excluded from the scope of §501(m).

Yours truly,

Arthur D. Pinkham

Arthur D. Pinkham, Jr.
Assistant Treasurer

THE
GEORGE
WASHINGTON
UNIVERSITY
*Washington, D.C. 20052 / Development Office / (202) 994-6415*

June 29, 1987

Robert J. Leonard, Chief Counsel
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Dear Mr. Leonard:

I am writing to ask your help in correcting a situation that could have alarming consequences for colleges, universities and other charities that rely on the charitable gift annuity as an important source of financial support.

I join with many, many other colleagues in higher education to urge that you amend the Technical Corrections Act of 1987 (H.R. 2636) to clarify that charitable gift annuities issued by IRC Sec. 501(c)(3) organizations are not "commercial-type insurance" under IRC Sec. 501(m) and are not subject to that section of the code. This particular section of the Internal Revenue Code--enacted by the Tax Reform Act of 1986--could be misinterpreted to treat charitable gift annuities as "commercial-type insurance". If charitable gift annuities were viewed as "commercial-type insurance", charities would be taxed as insurance companies on their gift annuity programs or, in extreme cases, would lose their tax exemption altogether. I am convinced that this severe result was not the intention of the framers of the new tax law. However, unless an effort is made to clarify the nature of charitable gift annuities, many charities will suffer significant decreases in their financial support.

I would like to emphasize the following points:

1. Gift annuities are often a very appropriate giving instrument for older people of some means who wish to make a gift to help our institution.

2. Gift annuities definitely are not "commercial-type insurance" and do not compete with commercial annuities.

3. For over 100 years, gift annuities have been a popular means of support of many charitable organizations.

4. If the law is not clarified, an important source of funds for the educational activities of our institution will cease to exist.

5. For the small donor, a charitable gift annuity is the equivalent of a large donor's charitable remainder annuity trust, which is unaffected by IRC Sec. 501(m).

By sponsoring or supporting such an amendment, you will be helping to correct an unintended inequity in the new tax law that could have dire consequences for many American charities that rely heavily on income from the charitable gift annuity source.

Thank you.

Sincerely,

Jerry R. Anderson

Jerry R. Anderson
Director of Planned Giving

Harvard Medical School
25 Shattuck Street, Boston, Massachusetts 02115
(617) 732-1530

July 6, 1987

Robert J. Leonard, Chief Counsel
House Committee on Ways and Means
1102 Longworth House Office Building
Washington, DC 20515

Dear Mr. Leonard:

I am writing on behalf of Harvard Medical School regarding the potential taxation of charitable gift annuities under Section 501(m) of the Tax Reform Act.

Gift annuities have been used in the charitable community for over 100 years. A donor decides to make his/her gift to help Harvard Medical School, not so that he/she will receive annuity payments. If the income payment was the primary concern, these individuals would be purchasing commercial annuity contracts whose payment rates are far more generous. Charitable gift annuities are not "commercial-type insurance", and therefore do not compete with commercial annuities.

One might look at the charitable gift annuity as being the equivalent of a wealthy donor's charitable remainder annuity trust, which is unaffected by Section 501(m). Because gift annuities are such an attractive form of giving for many who are unable to consider making a large gift (our minimum gift annuity amount is $5,000 while our annuity trust minimum amount is $50,000), failing to clarify the law would dry up an important source of funds for Harvard Medical School, as well as for all charitable institutions. We need your help in clarifying that Section 501(m) does not apply to gift annuities.

Please ammend the Technical Corrections Act of 1987 (H.R. 2636) to clarify that charitable gift annuities issued by IRC Sec. 501(c)(3) organizations are not "commercial-type insurance" under IRC Sec. 501(m).

Thank you.

Sincerely,

Jon E. Abrams

Jon E. Abrams
Director of Planned Giving

**Office of President Jacksonville, Il. 62650 (217) 245-7126**

**Illinois College**

June 30, 1987

Mr. Robert J. Leonard
Chief Counsel
Committee on Ways and Means
U.S. House of Representatives
Room 1102
Longworth House Office Building
Washington, D.C. 20515

Dear Mr. Leonard:

Congress is currently considering the Technical Corrections Act of 1987 (H.R. 2636). I am specifically interested in IRC Sec. 501(m). I am writing to urge you to clarify this section so that colleges are not considered commercial-type insurance corporations under IRC Sec. 501(m) as colleges accept gifts for life annuities from their alumni and friends.

The gift annuity is simply a device for a private college to provide income to a donor who desires to make a substantial gift to the college. The gift annuity is not a major activity of private colleges, and in no way is the college a commercial-type insurance company.

Our donors want to use gift annuities because they want to help Illinois College. These gift annuities do not compete with commercial-type insurance. If this is not clarified in the Technical Corrections Act, then we will be deprived of an important source of funds for Illinois College.

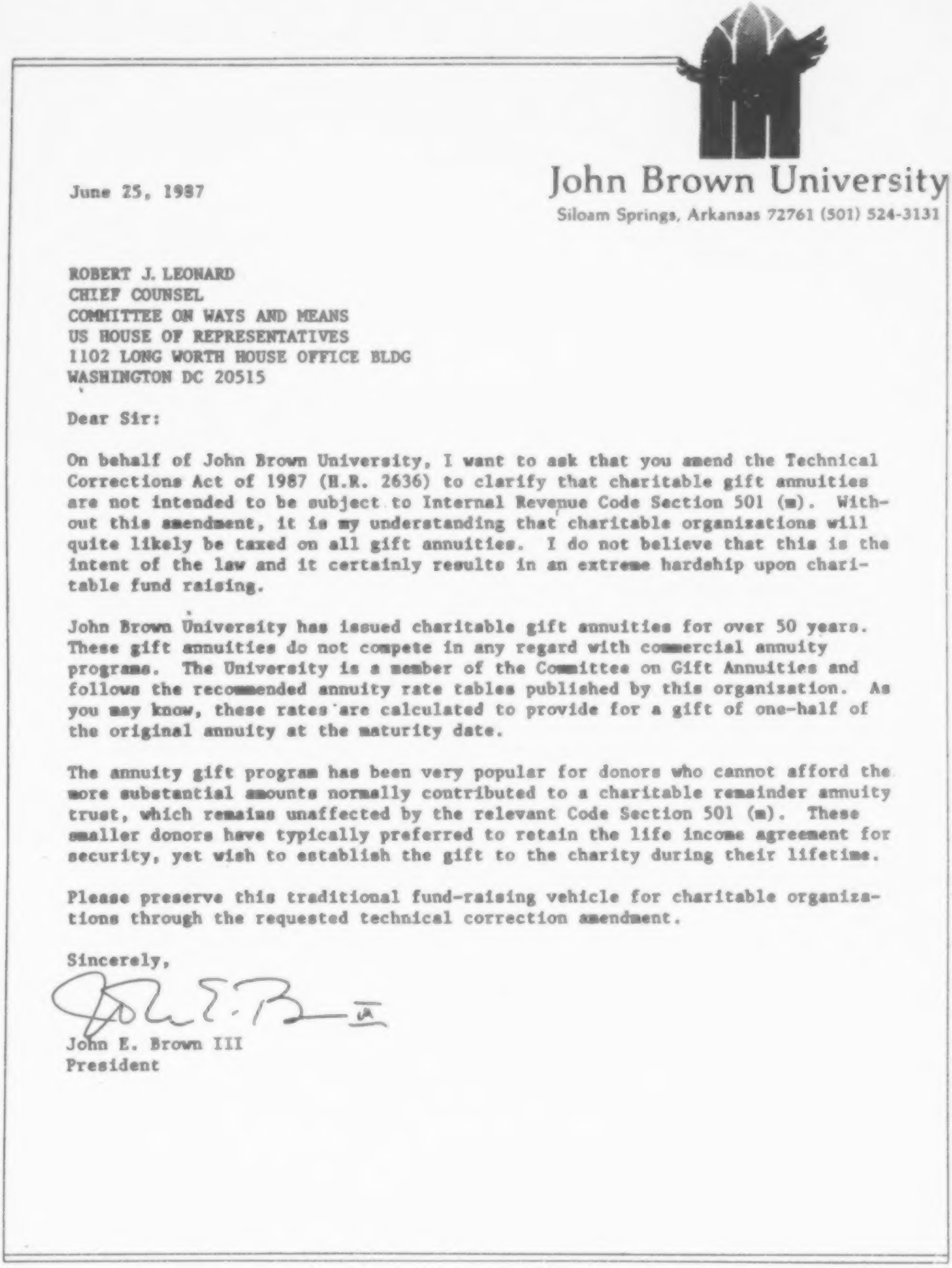
I should like to point out that my predecessors for the past 100 years have used annuities to help build Illinois College. Gift annuities have been important to us. I also point out that for our small donors, and that is essentially what we have at Illinois College, the gift annuity is comparable to the large donor's charitable remainder trust which continues to be unaffected by IRC Sec. 501(m).

I know that you are a friend of higher education, and especially of the dual system, private and public. I urge you to take this matter in hand and work for the clarification of the gift annuity arrangement under the Technical Corrections Act currently under consideration.

Thank you for your time and for your assistance.

Sincerely,

Donald C. Mundinger
President



John Brown University
Siloam Springs, Arkansas 72761 (501) 524-3131

June 25, 1987

ROBERT J. LEONARD
CHIEF COUNSEL
COMMITTEE ON WAYS AND MEANS
US HOUSE OF REPRESENTATIVES
1102 LONG WORTH HOUSE OFFICE BLDG
WASHINGTON DC 20515

Dear Sir:

On behalf of John Brown University, I want to ask that you amend the Technical Corrections Act of 1987 (H.R. 2636) to clarify that charitable gift annuities are not intended to be subject to Internal Revenue Code Section 501 (m). Without this amendment, it is my understanding that charitable organizations will quite likely be taxed on all gift annuities. I do not believe that this is the intent of the law and it certainly results in an extreme hardship upon charitable fund raising.

John Brown University has issued charitable gift annuities for over 50 years. These gift annuities do not compete in any regard with commercial annuity programs. The University is a member of the Committee on Gift Annuities and follows the recommended annuity rate tables published by this organization. As you may know, these rates are calculated to provide for a gift of one-half of the original annuity at the maturity date.

The annuity gift program has been very popular for donors who cannot afford the more substantial amounts normally contributed to a charitable remainder annuity trust, which remains unaffected by the relevant Code Section 501 (m). These smaller donors have typically preferred to retain the life income agreement for security, yet wish to establish the gift to the charity during their lifetime.

Please preserve this traditional fund-raising vehicle for charitable organizations through the requested technical correction amendment.

Sincerely,

John E. Brown III
President

LAKE
FOREST
COLLEGE

July 8, 1987

Mr. Robert J. Leonard, Chief Counsel
House Committee on Ways and Means
1102 Longworth House Office Building
Washington, DC 20515

Dear Mr. Leonard:

I understand that the pending technical corrections bill covering various details of the Tax Reform Act of 1986 does not eliminate the possibility that charitable gift annuities may generate taxable unrelated business income for charitable organizations.

Rapid and unforeseen change takes its toll on the lives and fortunes of many people. Fortunately, most people are able to accept this reality because of their underlying confidence, flexibility, and intelligence.

The people and institutions of this nation do not, however, like being blind-sided by capricious and arbitrary change coming directly from government. It is precisely in this light that we see the impact of section 501 (m) of the 1986 Tax Reform Act on the issuance of charitable gift annuities. To subject charitable gift annuities to an unrelated business income tax would completely disrupt their true status as gifts. Government should not come between individual donors, who see gift annuities primarily as charitable gifts, and the many charitable organizatione which depend so much on this long-standing category of gifts.

We urge favorable clarification of this important issue.

Sincerely,

Eugene Hotchkiss

Office of the President
Sheridan and College Roads
Lake Forest, Illinois 60045
(312) 234-3100

Lawrence University
Development Office

July 3, 1987

Robert J. Leonard, Chief Counsel
House Committee on Ways and Means
1102 Longworth House Office Building
Washington, D.C. 20515

Dear Mr. Leonard,

I write to comment on the technical corrections bill in its relationship to section 501(m) of the Internal Revenue Code of 1986. Specifically, I want to urge that the bill make clear a point about which there is currently some confusion -- that charitable gift annuities do not fall within the scope of that section.

Section 501(m) was created by the Tax Reform Act of 1986 and provides that tax-exempt organizations deriving a substantial portion of their revenue from "commercial-type" insurance may be subject to the unrelated business income tax on that revenue. Annuities are properly considered to be commercial-type insurance for purposes of that section, but the new law seems ignorant of the distinction between charitable gift annuities and commercial annuities, and it has been reported that some congressional staff believe that section 501(m) should apply to gift annuities.

In fact, however, gift annuities -- like pooled income funds, charitable remainder annuity trusts and unitrusts, and gifts of real property with retained life estate -- do not represent a private investment option but are, rather, a means of making an irrevocable charitable gift while retaining an income from the gift property. Gift annuities are, in fact, the oldest form of life income gift, having been issued since the early part of this century, and they have never been treated as an unrelated trade or business. (IRC section 514(c)(5), added by the Tax Reform Act of 1969 and unchanged in the 1986 law, makes this clear.)

An irrevocable donation to a charity, accompanied by a promise from the charity to pay a stated annual income for life, is completely different in character from the lump-sum or installment purchase of an income stream from a commercial insurer. Only private purposes are served by the latter, but the former always results in a substantial and permanent transfer of value to the issuing institution, thus advancing the public weal by supporting the mission of a non-profit educational, cultural, scientific, medical, or charitable institution.

Appleton, Wisconsin 54912 414-735-6517

In the case of a commercial annuity, the purchaser simply converts financial assets from one form to another and the issuing company gains the opportunity for a profit on the transaction. But in a gift annuity, the donor voluntarily contributes finanical assets to a charity, and the income stream received in return is always a fraction of the value of the contributed property. The commercial annuity is an investment, intended to safeguard or enhance the financial condition of the purchaser. But the gift annuity is a charitable contribution; the donor gives up property in order that the purposes of a charity may be advanced.

Far from representing an unrelated trade or business, then, gift annuities are simply and strictly another form in which those interested in our nation's charities exercise their financial support of those institutions and their exempt missions. It is difficult to understand the logic that would identify these contributions with a commercial purpose.

Since confusion has arisen, however, as to whether Code section 501(m) applies to gift annuities, clarification is needed. Accordingly, because the Internal Revenue Code, in section 514(c)(5), already contains provisions governing the application of UBTI to gift annuities, and because careful analysis discloses that charitable gift annuities are absolutely different in purpose and in result from commercial annuity products, I would urge that the technical corrections bill clarify that Code section 501(m) does not apply to charitable gift annuities.

Thank you for your consideration.

Sincerely,

Stephen A. Hirby

Stephen A. Hirby
Director of Development
414/735-6553

Marianist Mission
MR. GREGORY P. OLBERDING
PLANNED GIVING DEPARTMENT
9001 MONTGOMERY ROAD
CINCINNATI, OHIO 45242

July 17, 1987

Honorable Bill Gradison
U. S. Representative, Second Ohio District
2311 Rayburn Building
Washington, D. C. 20515

Dear Representative Gradison,

As a representative from my congressional district and member of the House Ways and Means Committee, you will shortly be called upon to consider the Technical Corrections Act of 1987 (H.R. 2636).

Within that Act you will consider, under IRC Sec. 501 (m), "commercial-type insurance."

I am concerned that charitable gift annuities, about which the bill is silent, will be treated and taxed as "commercial-type insurance," which they most certainly are not.

Charitable gift annuities have been issued by charitable and not-for-profit organizations for over 100 years. The donor to whom they are issued, wishes to make a gift to help the cause, in a larger amount than the usual current and out-of-pocket gift.

Most of the gift annuities issued through me by the Marianist Mission are for $1,000 (53%). Another 18 percent are for $2,000. The Marianist Mission follows the actuarial policies and practices of the Committee on Gift Annuities, which figures the actual gift value at about 50 percent, which is the difference between the charitable gift value and the full 100 percent taxable return of a commercial gift annuity.

Failure of the House Ways and Means Committee to clarify the law at this point would dry up an important source of funds for the charitable works of the Marianist Mission (which includes some support for Moeller and Purcell-Marian High Schools and the Marianists teaching there). Lack of clarification would also hinder the more than 1300 members of COGA (a great majority of charitable gift annuity writing institutions), who willingly join in the COGA rates to withstand the unwholesome competition of spiraling rates.

Further, a charitable gift annuity for the small donor is the equivalent of a large donor's charitable remainder annuity trust, which is not mentioned and is unaffected by this same IRC Section 501 (m). So why discriminate?

Finally, I would point out that most of the Marianist Mission donors who take out charitable gift annuities follow the same pattern as with other charities: they are over age 65, (96% of ours), they live on fixed incomes and do not itemize deductions. In fact, many tell me not to bother sending the annual W-2P form because they do not use it.

The point is that I am asking you to make a positive stand by specifically exempting charitable gift annuities from Section 501 (m) instead of allowing for the possibility of having that section misinterpreted and taxing charitable income.

Please use your vote to amend the Technical Corrections Act to clarify that charitable gift annuities issued by the IRC Sec. 501 (c) (3) organizations (not-for-profit institutions) are not subject to IRC Sec. 501 (m).

Please speak up with your colleagues for this express clarification. Thank you for your positive consideration.

Sincerely,

Greg Olberding

Gregory R. Olberding
Director of Planned Giving

*ROLAND C. MATTHIES*
**DEFERRED GIVING CONSULTANT**

**1205 Vester Avenue**
**Springfield, Ohio 45503**
**Phone (513) 399-7235**

June 25, 1987

Mr. Robert J. Leonard
Chief Counsel, Committee on Ways and Means
U. S. House of Representatives
1102 Longworth House Office Building
Washington, D. C. 20515

Dear Mr. Leonard:

I urge the amendment of Technical Corrections Act of 1987 (H.R. 2636) to clarify that charitable gift annuities issued by IRC Sec. 501(c)(3) organizations are not "commercial-type insurance" under IRC Sec. 501(m).

I write from long experience:

1. Forty-four years of fund raising at Wittenberg University, Springfield, Ohio.
2. Long-time Vice Chairman of the Committee on Gift Annuities.
3. Founding Chairman of the Lutheran Church in America Foundation.
4. Past-Chairman of the 501(c)(3) group.

From my long experience I can state with a certainty that charitable gift annuities are utilized by charitably-inclined donors who are seeking to make a substantial gift while alive and yet not deny themselves necessary lifetime income. In these many years of experience, I have never once had a potential donor say to me that we were competing with commercial insurance companies.

Wittenberg University wrote its first charitable gift annuity in 1872 and has been the recipient of many, many benefactions through this source. I firmly believe that failure to clarify the present law would dry up an important source of funds for our organization and for other charitable organizations with which I am associated.

American Bible Society is a perfect example of the beneficial impact of thousands and thousands of small charitable gift annuities. Many of these annuities are written for as small an amount as one hundred dollars--surely nothing to compete with commercial-type insurance. Our highly ethical organizations continually emphasize that the first motivation is for a donor to want to make a gift, and being able to make that gift during lifetime rather than after death provides great satisfaction to the donor.

These are times for encouraging and increasing charitable gifts. I urge your favorable consideration for this amendment to be adopted.

Sincerely,

Roland C. Matthies

THE
MERCERSBURG
ACADEMY

June 30, 1987

Mr. Robert J. Leonard, Chief Counsel
House Committee on Ways and Means
1102 Longworth House Office Building
Washington, DC 20515

Dear Mr. Leonard:

It is my understanding that the technical corrections bill for the Tax Reform Act of 1986 still fails to clarify that charitable gift annuities are not subject to the unrelated business income tax. Reading of Section 501(m) of the Tax Reform Act seems to make it clear that charitable gift annuities are not commercial insurance; therefore they should not be subject to unrelated business income tax. It would seem to me that a technical corrections bill should correct a situation such as this.

Where charitable giving is concerned, the 1986 Tax Reform Act breaks historic precedence, by adding new provisions to the tax law which are disincentives to give. There is a disincentive for wealthy Americans to make gifts of appreciated property, such gifts being made subject to the alternate minimum tax. There is even less encouragement from the Tax Act for less-affluent Americans to continue to give. Not only does the Tax Act eliminate the charitable deduction for those who do not itemize; it might even eliminate deductions for smaller donors who have traditionally tended to make charitable gift annuities.

I urge that the technical corrections bill include a clarification of the fact that charitable gift annuities are not subject to unrelated business income tax because they are not commercial insurance under Section 501(m) of the Tax Reform Act of 1986.

Sincerely,

Don Hill

Don D. Hill
Assistant Headmaster

Mercersburg, Pennsylvania 17236 Telephone: 717 328-2151

Mid-America Union
CONFERENCE OF SEVENTH-DAY ADVENTISTS

8550 PIONEERS BLVD.
P. O. BOX 6128
LINCOLN, NEBRASKA 68506
(402) 483-4451

June 30, 1987

Robert J. Leonard
Chief Counsel
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington DC 20515

Dear Sir,

Many heartland farmers appreciate the opportunity of making a modest gift to their college, academy, or church through the Charitable Gift Annuity Plan. They often do not have the large incomes which would make a Charitable Remainder Annuity Trust feasible. Should they be denied the tax advantage of the larger donors?

I urge you to amend the Technical Corrections Act of 1987 (HR2636) to clarify that charitable gift annuities issued by IRC Section 501C3 organizations are not commercial type insurance under the IRC Section 501 M.

I wrote my first Charitable Gift Annuity back in 1966, and over the years I've watched the benefits brought to the elderly donors who need a steady income, as well as to the receiving charitable organizations. I fear that taxing these gift annuities would dry up this source of funds for our charitable organizations.

Thank you for remembering the little fellow who loves his church.

Sincerely yours in Christ's service,

George Woodruff

George Woodruff, Director
Trust Services

**Missionary Oblates of Mary Immaculate**
NATIONAL SHRINE OF OUR LADY OF THE SNOWS • BELLEVILLE, IL 62222

July 6, 1987

Representative Bill Archer
1135 Longworth
House Office Building
Washington, DC 20515

Dear Representative Archer,

As Annuity Director of the Missionary Oblates at the National Shrine of Our Lady of the Snows in Belleville, Illinois, I urge you to do what you can to amend the Technical Corrections Act of 1987 (H.R. 2636) to clarify that Charitable Gift Annuities issued by IRC Sec. 501(c)(3) organizations are not "commercial-type insurance" under IRC Sec. 501(m).

We have been working with the poor and impoverished since our congregation began. All our support comes from charitable contributions, and without them we would not be able to continue our work in the foreign missions as well as with the homeless, the native Americans, and other needy groups in this country. For over 25 years, a large portion of our support has come from our annuitants.

We feel that our annuitants join our Charitable Gift Annuity Program mostly because they wish to give a gift. Many of our annuitants are "small donors" and would not be able to give a gift if they did not have some minimum income. The Charitable Gift Annuity gives them the opportunity to both make a gift and also have some security for their future. The Charitable Gift Annuity is for the "small donor" the equivalent of a "large donor's" Charitable Remainder Trust, which is unaffected by IRC Sec. 501(m).

I thus urge you, Representative Archer, to do what you can to see that Charitable Gift Annuities continue to have the same tax status as they had prior to the Tax Reform Act of 1986. Thank you very much.

Sincerely yours,

Fr. Don Ferguson

Fr. Don Ferguson, OMI

**Moravian College**
Bethlehem, Pennsylvania 18018

OFFICE OF THE PRESIDENT

July 7, 1987

Robert J. Leonard, Chief Counsel
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Bldg.
Washington, DC 20515

Dear Mr. Leonard:

For over 100 years, the charitable gift annuity has been an accepted and effective method of charitable giving. The charitable gift annuity enables the average donor to make a significant gift to his or her favorite charitable institution and enjoy benefits similar to those afforded the wealthy donor, who is able to create a charitable remainder annuity trust. The Tax Reform Act of 1986 has raised the possibility that this gift vehicle may no longer be available. Section 1012 of TRA '86 amends IRC Section 501(m) such that it may be interpreted to treat charitable gift annuities as "commercial-type insurance." If this happens, charities would be taxed as insurance companies on their gift annuity programs or, in extreme cases, lose their tax exemption altogether.

I would ask that you please do what you can to see that the Technical Corrections Act of 1987 (H.R. 2636) is amended to clarify that charitable gift annuities issued by IRC Sec. 501(c)(3) organizations are not "commercial-type insurance" under IRC Sec. 501(m). Gift annuities are used because the donor's primary motivation is to make a gift; if it were otherwise, the donor would certainly opt for the much higher rates available through commercial annuities. For this same reason, it is difficult to perceive the charitable gift annuity as a serious competitor of the commercial annuity. The rates are such, that the commercial annuity is usually 40-50% cheaper than the gift annuity. Based on this information, it is difficult to consider the gift annuity anything but a charitable vehicle.

If IRC Sec. 501(m) is not clarified, an important source of funds,--not only for Moravian College but for hundreds of colleges, universities, hospitals and health-care agencies, youth agencies, and other charitable organizations--will dry up. The result will be either a cutback in services, increased costs to the constituent, or greater reliance on federal dollars.

Your support for a clarification of the law will be greatly appreciated and will be of significant help to the charitable institutions of this country.

Thank you for your interest.

Sincerely,

Roger H. Martin

*The Nation's Sixth Oldest College*

**National Easter Seal Society**

*2023 West Ogden Avenue*
*Chicago, Illinois 60612*
*312 243.8400 (phone)*
*312 243.8880 (TDD)*

June 24, 1987

Congressman Dan Rostenkowski
House of Representatives
2111 Rayburn
Washington, D. C. 20515

Dear Congressman Rostenkowski:

The purpose of this letter is to encourage you, as a member of the House Ways and Means Committee representing the people of Illinois, to include in the Technical Corrections Act of 1987 (H.R.2636) an amendment regarding charitable gift annuities issued by qualified charitable organizations.

It is my understanding that the Tax Reform Act of 1986, specifically IRC Sec. 501(m), could be misinterpreted and treat charitable gift annuities as commercial type insurance, with the result that charities would be taxed on their charitable gift annuity program and possibly jeopardize their tax exempt status. This, in my opinion, would be a serious mistake and do an injustice not only to charitably minded people but also to the charities they wish to support in a significant way.

The charitable gift annuity program of the twenty-two affiliated societies in Illinois and the 400+ societies across the nation is still in its infancy, due in large part to the urgent need for the development staff to raise "now" dollars and to the relatively unsophisticated donors attracted to our cause. But it was just for these types of donors - the good-hearted people of middle income America - that the charitable gift annuity was originally created and for whom it should be retained as a viable gifting arrangement.

The majority of our donors are not wealthy people. They need whatever they have accumulated during their lifetimes to provide income for themselves during their retirement years. Through our societies' programs we are trying to inform them that their personal objective and charitable objective are very compatible, that they can endow their annual giving in ways that will not jeopardize their current financial needs. Being able to offer these donors the charitable gift annuity is an integral part of our planned giving programs because the charitable gift annuity can be funded at the $2-5,000 level. This allows our donors to perpetuate their values beyond their lifetimes and our

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Easter Seal Societies to ensure our capabilities of providing services for people with disabilities into the 21st Century.

As a development professional having represented a major university, an international social service organization and now a national health service organization, let me assure you that I have never competed with commercial type insurance companies and that at all times the intent of the donors entering into charitable gift annuity contracts with the above organizations was to make a significant and affordable gift for the charitable causes they believed in. Please use the position you have on this important House Committee and your awareness of this problem to guarantee the viable use of the charitable gift annuities by our nation's charitable organizations.

Sincerely,

David G. Schmeling

David G. Schmeling, CFRE
Planned Giving Consultant

NEW MEXICO
BAPTIST

June 29, 1987

Mr. Robert J. Leonard, Chief Counsel
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Dear Mr. Leonard:

A fine effort was put forward in TRA '86. However, a clarification is desperately needed. Charitable Gift Annuities issued by IRC Sec. 501(c)(3) organizations are not "commercial- type insurance" under IRC Sec. 501(m). So many smaller donors seek this avenue of gifting because they can not use their larger donor equivalent, the charitable remainder annuity trust. These good people desire to support the cause of Christ, but most often need this vehicle to exercise their donative intent.

I trust you and your colleagues will resolve this very serious matter in favor of small donors and charities. Please consider the consequences to our charity and others of classifying gift annuities as "commercial-type insurance." A failure to allow gift annuities will result in a tremendous loss by all 501(c)(3)s not to mention the impact upon middle America. How will we replace this source of donations? How will smaller donors be able to participate in supporting Christian child care and the spreading of the gospel with this gifting method lost?

Please consider the consequences of classifying gift annuities as "commercial-type insurance." Your help is sought in ammending TCA of 1987 (H.R. 2636) to assure continued use of gift annuities by all 501(c)(3) organizations.

Respectfully submitted,

B. Lee Black

B. Lee Black, President
New Mexico Baptist Foundation

P.O. BOX 485 ALBUQUERQUE, NEW MEXICO [illegible]

· OHIO · WESLEYAN ·

Ohio Wesleyan University
Delaware, Ohio 43015
Telephone 614-369-4431

July 2, 1987

Mr. Robert J. Leonard, Chief Counsel
House Committee on Ways and Means
1102 Longworth House Office Building
Washington, D.C. 20515

Dear Mr. Leonard:

Since the passage of the 1986 Tax Reform Act much confusion has existed about the advisability of colleges continuing to offer charitable gift annuities to alumni, parents and friends. For many decades this form of contribution has been a popular one among our alumni, particularly those not able to make large enough gifts to establish separate trusts.

We had been led to believe that the Technical Corrections Bill covering details of the Tax Reform Act now pending before both the House and Senate would address this issue. I have recently been told that this is not the case. I hope very much that the Technical Corrections Bill will clarify that charitable gift annuities are not subject to the unrelated business income tax because they are not commercial insurance under Section 501(M) of the Tax Reform Act of 1986.

Your attention to this issue which is of great concern to thousands of colleges and universities throughout the country will be very much appreciated.

Sincerely yours,

Robert A. Holm
Vice President for University Relations

Otterbein Homes
585 N. STATE ROUTE 741 LEBANON, OHIO 45036
(513) 932-2020

DR. CHARLES K. DILGARD
*Chief Executive Officer*

MR. DONALD E. PATTERSON
*Executive Director, Corporate Development*

DR. HOWARD P. SPITNALE
*Associate Director, Corporate Development*

June 22, 1987

Robert J. Leonard, Chief Counsel
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Dear Mr. Leonard:

I understand that a question has been raised as to whether charitable gift annuities are subject to taxation under Section 501(m) of the Internal Revenue Code enacted by the Tax Reform Act of 1986. That provision, from my understanding, was designed to tax the "commercial-type insurance" activities of certain tax-exempt organizations, and was not thought to apply to charitable gift annuities.

There is some talk now suggesting that it may be applicable.

I should like to voice very strongly my feelings and reasons that the provisions should not apply to charitable gift annuities.

I am Executive Director of Development for Otterbein Homes, which is a church-related, non-profit, comprehensive retirement community in south-western Ohio. We have a total of 725 retirees in our Lebanon facility, and 100 residents in our newly-acquired Portage Valley nursing home in northwestern Ohio. Our combined nursing facilities make Otterbein Homes the largest nursing home in Ohio, and among the largest retirement communities in the entire nation.

This factual background is important, because as a non-profit, Christian organization, we depend a great deal on financial support from thousands of individuals. A large part of this financial support comes in the form of charitable gift annuities every year. We have been serving the elderly for 75 years. (For 50 years we also served children as a part of our mission.) For many of these years we have offered charitable gift annuities as a part of our fund-raising activities. Many of our supporters find charitable gift annuities a very desirable way to make gifts to our organization. Their basic desire is to help their elderly "neighbors"...not the income benefits they receive.

Most of our donors are "small" donors, and I feel the charitable gift annuity for them is the equivalent of a large donor's charitable

1912 - 1987
Otterbein Home
75 YEARS OF CARING

remainder annuity trust, which I understand is unaffected by Section 501(m).

The "charitable community" in this country would suffer a great financial loss if it is decided that Section 501(m) of the Internal Revenue Code (as enacted by the Tax Reform Act of 1986) should apply to charitable gift annuities.

Every year Otterbein Homes provides $500,000 to $600,000 in free financial help to our residents who cannot pay for their total cost of care. No resident has ever been asked to leave our facility in 75 years because they ran out of money. This benevolent care program is supported by deferred giving programs such as our charitable gift annuities.

Please cast your vote AGAINST any possible taxation of these charitable gift annuities which mean so much to the financial stability of so many non-profit organizations in this country.

Otterbein Homes is a sponsoring member of the Committee on Gift Annuities and follows the recommended guidelines of this group. As such a member, I would greatly appreciate your personal leadership in clarifying the exemption of charitable gift annuities from Internal Revenue Code Section 501(m).

Thank you for hearing my story. Your help would be greatly appreciated.

Sincerely yours,

OTTERBEIN HOMES

Donald E. Patterson

Donald E. Patterson
Executive Director
Corporate Development

**Our Lady of Victory Homes of Charity**
*Father Baker's*

LACKAWANNA, NEW YORK 14218
716-827-9640

MSGR. ROBERT C. WURTZ
Executive Vice President & Treasurer

I am writing to respectfully request that the Technical Corrections Act of 1987 (H.R. 2636) be amended to state clearly that charitable gift annuities are not subject to IRC Sec. 501(m). They are not commercial-type insurance.

Gift annuities are unique instruments, issued by non-profit (IRC Sec. 501(c)3) organizations as giving vehicles. They are of special interest to small donors because through annuities they are able to provide more significant support to their charitable concerns. The charitable annuity trust, used by large donors, is unaffected by IRC Sec. 501(m).

The Committee on Gift Annuities has recommended since 1939, and it is current New York State Insurance Law, that a residuum of 50% be available to the charitable organization at the death of the annuitant. This underscores and substantiates our contention that charitable gift annuities are primarily a gift; they are not "commercial-type insurance" and do not compete with commercial annuities.

Charitable gift annuities are not new; they have been used by charities for over a century. Failure to clarify the law could seriously reduce a well-accepted and important source of funds to help sustain work in our country.

I urgently solicit your support to amend the Technical Corrections Act of 1987 and maintain the charitable gift annuity as a viable giving vehicle, to help keep the non-profit sector financially sound through voluntary donations.

Sincerely In Christ,

Msgr Robert C Wurtz

Msgr. Robert C. Wurtz
Executive Vice President
and Treasurer

**ANDOVER** / PHILLIPS ACADEMY · ANDOVER, MASSACHUSETTS 01810 · TELEPHONE 617 / 475-3400

July 9, 1987

Robert J. Leonard, Chief Counsel
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, DC 20515

Dear Mr. Leonard,

I am writing to you on behalf of Phillips Academy, an independent secondary school in Andover, Massachusetts, to urge you and the House Ways and Means Committee to amend the Technical Corrections Act of 1987 (H.R. 2636) as it relates to charitable gift annuities. This act needs to be clarified to reflect that charitable gift annuities as issued by non-profit, charitable organizations such as Phillips Academy will not be defined as or misconstrued to be "commercial-type insurance."

If the bill is left as unclear as it now reads, then charitable organizations across the country would find themselves to be taxed just like insurance companies. Our school does not provide commercial insurance to its alumni, alumnae, parents and friends through its gift annuity program, but that is how the existing section 501(m) of the Tax Reform Act could be read to imply.

I urge you to look again at this section and its implications for the middle income supporter of a non-profit organization. These donors do not have the funds to create a gift through a vehicle such as the unaffected charitable remainder annuity trust, yet they are just as eager to assist their favorite charity.

Phillips Academy has several existing gift annuities which have been created since October 1985 when our trustees approved the use of them as a planned giving vehicle. The trustees saw charitable gift annuities as a flexible means of responding to the smaller donor who cannot presently afford to seriously deplete his or her income flow, yet would like to make a significant gift to the school to support scholarships, faculty salaries, sports, maintenance, general endowment or operating costs.

Please reconsider the effects of this section on charitable gift annuities and amend the Technical Corrections Act of 1987 (H.R. 2636) to remove gift annuities from a faulty designation as "commercial-type insurance."

Thank you.

Sincerely,

Grace E Curley

Grace E. Curley
Director of Planned Giving

Presbyterian
Church
in
America
Foundation

John W. S. Hudson
Director

4319 Memorial Dr. / Suite A-2 / Decatur, Georgia 30032 / (404) 296-9755

July 7, 1987

Mr. Robert J. Leonard, Esq.
Chief Counsel, Committee on Ways and Means
U. S. House of Representatives
Rm. #1102, Longworth House Office Building
Washington, DC 20515

Dear Mr. Leonard:

The PRESBYTERIAN CHURCH IN AMERICA FOUNDATION is deeply concerned about the omission in the Technical Corrections Act (IRC Sec.501(m) of a specific exemption of charitable gift annuities from that legislation. I am writing to request your assistance to influence the amending of this legislation so as to clearly and unmistakably state that charitable gift annuities are not "commercial-type insurance" under IRC Sec.501(m). Gift Annuities are used to enable an interested donor to make a gift through the PCA Foundation to the various Ministries of our denomination. Due to their sacramental nature they do not compete with commercial promotions of annuities and are the small donor's equivalent of a Charitable Remainder Annuity Trust - which are used by large donors. As you are certainly aware, the Charitable Remainder Annuity Trust is not affected by IRC Sec.501(m).

The PRESBYTERIAN CHURCH IN AMERICA FOUNDATION is deeply concerned about the lack of clarity as the Act now stands, as we feel this uncertainty would surely lead to a serious decline in a significant source of funds for our Ministries, and would also penalize many of our older communicant/donors who rely on the PCA Foundation to help enable them to stay independent of public assistance programs, even though some are on very limited incomes. This type of annuity has been used by various non-profit and charitable organizations of all types for over 100 years, and represents a substantial portion of our Ministry.

Please exert your utmost influence and persuasive power to see that this amendment is sufficiently clarified that there can be no doubt about the interpretation.

Sincerely,

John W. S. Hudson

John W. S. Hudson
Director

Saint Louis Symphony Orchestra

POWELL SYMPHONY HALL
718 NORTH GRAND BOULEVARD, ST. LOUIS, MISSOURI 63103
PHONE: (314) 533-2500
TELEX: 434450 STLSYMORCH STL

**Leonard Slatkin, Music Director and Conductor**
**David Hyslop, Executive Director**

The Saint Louis Symphony Society
Operating The Saint Louis Symphony Orchestra,
The Saint Louis Symphony Chorus
& Powell Symphony Hall

June 23, 1987

Mr. Robert J. Leonard, Chief Counsel
Committee on Ways and Means
U. S. House of Representatives
1102 Longworth House Office Building
Washington, DC 20515

Dear Mr. Leonard:

I am writing to urge you and the members of the House Ways and Means Committee, as well as Congress, to amend the Technical Corrections Act of 1987 to clarify that charitable gift annuities are not subject to IRC Sec.501(m).

As I'm sure you are aware, charitable organizations make use of the gift annuities as a way of making an alternative gift to our organizations instead of outright cash. Also, we feel strongly that gift annuities do not compete with commercial annuities and are not "commercial-type insurance." If this issue is not amended, it will eliminate a vehicle of giving to charitable organizations.

On behalf of the Saint Louis Symphony Orchestra, I would again urge the Ways and Means Committee to amend and clarify the Technical Corrections Act of 1987 (H.R.2636) that charitable gift annuities are not subject to IRC Sec.501(m).

Thank you for your consideration.

Kindest regards,

Richard R. Hoffert
Director of Development

Saint Raphael
**Foundation, Inc.**

1450 Chapel Street
New Haven, Connecticut 06511

June 19, 1987

Mr. Robert J. Leonard, Chief Counsel
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Dear Mr. Leonard:

As the person charged with raising funds for the Hospital of Saint Raphael, I am very concerned that the Technical Corrections Act of 1987 (H.R. 2636) be amended to clarify that charitable gift annuities are not subject to IRC Sec. 501 (m).

Although our Hospital has no gift annuities in effect currently, I feel that they would have great appeal to many members of our constituency and ultimately benefit the Hospital.

Older auxilians, alumnae of our nursing school and physicians might find these vehicles an ideal way to help the Hospital while preserving necessary income during their lifetimes. Since the amounts used to set up an annuity are more modest than those needed to fund unitrusts and annuity trusts, I think they would have greater appeal to our prospective donors.

Please do whatever you can to restore this gift vehicle to the non-profit community.

Thank you.

Sincerely,

Jane D. Crowley
Executive Director

EVA BURROWS
GENERAL

STANLEY E. DITMER
TERRITORIAL COMMANDER

**THE SALVATION ARMY**
(INCORPORATED)
FOUNDED IN 1865 BY WILLIAM BOOTH
**TERRITORIAL HEADQUARTERS**
120 W. 14th STREET
NEW YORK, N.Y. 10011
TELEPHONE (212) 337-7200

June 24, 1987

The Honorable Charles B. Rangel
Room 2330
Rayburn House Office Building
Washington, D.C. 20515

Re: Technical Corrections Act of 1987 (H.R. 2636)

Dear Representative Rangel:

On behalf of the Eastern Territory of The Salvation Army we are writing to convey our deep concern that the above-captioned legislation remains silent with specific regard to clarifying that charitable gift annuities should not be subject to unrelated business income taxation under IRC Sec. 501(m). We urge your assistance in amending H.R. 2636 to continue the tax-exempt status of gift annuities that Congress properly recognized in 1969 under IRC 514 (c)(5).

You are aware that IRC Sec. 501(m), as presently drafted, would impose liability for unrelated business income tax on charitable gift annuities to restrict non-profit organizations from competing unfairly with insurance companies in the sale of commercial insurance products. The comparision of the two "products" is invalid and unfair because the competition does not exist. Charitable gift annuities issued by qualified 501 (c)(3) organizations never have and never can compete with commercial products. The rates of return on gift annuities are appreciably lower than those of their commercial counterparts due to the gift portion of the nonprofit agreement. Accordingly, the commercial annuity appeals to indivduals whose priority is the highest possible rate of return while the gift annuity appeals almost exclusively to those who wish to blend a compromised rate of return with an element of irrevocable charitable support. The markets are clearly distinct and do not compete.

The Eastern Territory of The Salvation Army has been offering charitable gift annuities to its many donors since January 31, 1941. Throughout the more than forty-six years since that time the gift annuity program has provided a practical and mutually beneficial channel for thousands of middle-income people to share in the continuity of our work. It has enabled them to make gift commitments that might normally exceed their means and helped us to carry on our diverse programs of caring for the many, many thousands of less fortunate individuals we help each year.

If the Technical Corrections Act of 1987 (H.R. 2636) is permitted to continue silent with regard to the clarification we seek in IRC 501(m) it will establish unwarranted and grossly unfair challenges to the above proven system of support. It will have the potential of eliminating a most effective method of giving enjoyed by a growing number of generous people at a time when the numbers of needy individuals who seek our help continue to rise.

We respectfully urge your support in amending H.R. 2636 to clarify that charitable gift annuities are not subject to IRC 501(m).

Thank you.

Sincerely yours,

Colonel Wallace C. Conrath
CHIEF SECRETARY

BILL SCHUETTE
10TH DISTRICT, MICHIGAN
AGRICULTURE COMMITTEE
SUBCOMMITTEES:
WHEAT, SOYBEANS AND FEED GRAINS
FORESTS, FAMILY FARMS AND ENERGY
SELECT COMMITTEE ON AGING
SUBCOMMITTEES:
RETIREMENT INCOME AND EMPLOYMENT
HOUSING AND CONSUMER INTERESTS
TASK FORCE ON THE RURAL ELDERLY

Congress of the United States
House of Representatives
Washington, DC 20515

415 CANNON BUILDING
WASHINGTON, DC 20515
(202) 225-3561

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P.O. BOX 631
MIDLAND, MI 48640
(517) 631-2552

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PARKVIEW PLAZA NORTH
CADILLAC, MI 49601
(616) 775-2722

300 WEST MAIN ST.
OWOSSO, MI 48867
(517) 723-8758
723-8750

July 10, 1987

The Honorable Dan Rostenkowski
Chairman
Committee on Ways and Means
1102 Longworth House Office Building
Washington, D.C. 20515-6348

Dear Mr. Chairman:

As you are aware, there has been some confusion over the treatment of charitable gift annuities after passage of the Tax Reform Act of 1987.

During your deliberations on the Technical Corrections Act, I urge you to clarify that charitable gift annuities not be treated as "commercial-type insurance." As you know, charitable gift annuities are not issued for the same reasons as commercial annuities, nor do they compete with commercial annuities. The loss of tax-exempt status for many section 501(c)(3) organizations would have very serious implications for their ability to raise needed funds. I ask that you give serious consideration to this provision of the Tax Reform Act in light of its significant importance to these organizations.

Thank you for your personal consideration of this important matter.

With warm regards,

Sincerely,

Bill Schuette
Member of Congress

PACIFIC
UNION
CONFERENCE
OF SEVENTH-DAY ADVENTISTS Box 5005, Westlake Village, CA 91359 • Telephone: (805) 497-9457 • Telex: 67-7018

June 30, 1987

Robert J. Leonard, Chief Counsel
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Dear Mr. Leonard:

I am writing to you on behalf of the Seventh-day Adventist churches, educational and medical institutions in the States of Arizona, California, Hawaii, Nevada and Utah.

We appreciate and support your work in considering the Technical Corrections Act of 1987 (H.R. 2636). Certain provisions of the Tax Reform Act of 1986 need clarification in order to prevent an application of the law in a manner inconsistent with the intent of Congress.

We believe that Congress did not intend to tax charitable organizations for their fund raising programs which are traditionally tax-exempt. Under Section 501 (m) of the Internal Revenue Code, as enacted by the Tax Reform Act of 1986, charities would be taxed as insurance companies if this provision is not further clarified as specifically not treating charitable gift annuities as "commercial-type insurance".

As presently worded, Section 501 (m) could be misinterpreted, resulting in charitable gift annuities being treated in the same manner as commercial annuities. These are two different types of annuities. Charitable Gift Annuities are used by donors primarily in order to make a gift to charity. Gift annuities are not used by charities in order to compete with insurance companies which issue commercial annuities. These companies issue commercial-type insurance and under these plans, the annuitants receive substantial benefits.

For over one hundred years now, charities have used gift annuities as a means of obtaining gifts from their donors. If Section 501 (m) is not clarified to allow Section 501 (c) (3) organizations to issue charitable gift annuities without being taxed as commercial-type insurance, an important source of funds for these charities' activities would be cut off drastically.

We do not believe that such result was the intent of Congress. Charitable Remainder Annuity Trusts, which are very similar to Charitable Gift Annuities, remain unaffected under the Tax Reform Act of 1986.

Please help clarify Section 501 (m) by amending the Technical Corrections Act of 1987. Your help will enable our organization to obtain gifts for funding its various activities. Thank you for your assistance in this matter.

Very truly yours,

John G. Tulio
General Counsel

2686 Townsgate Road, Westlake Village, California 91361

SHARP
HOSPITALS FOUNDATION

July 29, 1987

The Honorable Dan Rostenkowski
Chairman
House Ways and Means Committee
U.S. House of Representatives
Washington, D.C. 20515

Dear Mr. Rostenkowski:

I strongly urge that Technical Corrections Act of 1987 (H.R. 2636) be amended to clarify that charitable gift annuities are not subject to IRC Sec. 501(m).

We had hoped that the Technical Corrections Act, just introduced, would underscore that gift annuities aren't "commercial-type" under IRC Sec. 501 (m). Unfortunately, the bill does not cover this point.

Sharp HealthCare, one of San Diego's top ten employers and a leading not-for-profit organization, relies on philanthropic contributions to help maintain high quality medical care. Sharp HealthCare is a leader in cardiology, perinatal care, trauma care and rehabilitation, to name just a few of our premier services. The San Diego community relies on the quality and array of services that we currently provide.

We are urging members of the House Ways and Means Committee to amend the Technical Corrections Act of 1987 (H.R. 2636) to clarify that charitable gift annuities issued by IRC Sec. 501(C) (3) organizations are not "commercial-type insurance," under IRC Sec. 501 (m).

Non-profit status is absolutely mandatory for the fiscal viability of our organization and the health care services we can offer our community. We cannot let an oversight or omission in the legislation jeopardize the important life-saving services and the revenues non-profit status provides.

Again, we urge you to clarify and amend the Technical Corrections Act of 1987 to read that charitable gift annuities are within the purvue of IRS Sec. 501 (C) (3) non-profit entities and should not be classified as commercial-type insurance.

Sincerely,

Phyllis A. Allen
Senior Vice President
Sharp Hospitals Foundation & Public Affairs

Serving Sharp HealthCare

3131 Berger Avenue, Suite 200 • San Diego, CA 92123 • (619) 541-3000

The Society for
THE PROPAGATION OF THE FAITH
Most Reverend William J. McCormack, National Director
National Office: 366 Fifth Avenue • New York, NY 10001 • 212-563-8700

July 8, 1987

The Honorable Dan Rostenkowski
Chairman, House Ways & Means Committee
2111 Rayburn
House Office Building
Washington, D. C. 20515

Dear Representative Rostenkowski,

The Society for the Propagation of the Faith is the principal agency of the Roman Catholic Church to foster interest in all aspects of the Church's missionary activity, and to gather financial support for the most basic needs of the Church's worldwide missionary Apostolate. This is especially crucial in the Third World where the needs are so great.

With respect to gathering the financial support needed to accomplish this task, the Society has for more than fifty years, utilized a Charitable Gift Annuity program.

In 1986, the Charitable Gift Annuity program accounted for a significant part of our total fund raising effort.

The primary appeal of the Charitable Gift Annuity is that our benefactors can make a gift to their Church that will enable others to share in their common faith.

Many of our annuitants cannot even take advantage of the charitable deduction that is afforded them due to the elimination after 1986 of the charitable deduction for nonitemizers. Nevertheless, they still seek to use the Charitable Gift Annuity this year as a vehicle that permits them to make a gift to their Church.

The potential taxation of charitable gift annuities suggested through the application of Section 501(m) of the Internal Revenue Code enacted by the Tax Reform Act of 1986 would be a severe blow to our organization as well as many others.

I respectfully request in the name of the Society, Representative Rostenkowski, your assistance in amending the Technical Corrections Act of 1987 (H.R. 2636) to clarify that charitable gift annuities issued by IRC sec. 501(c)(3) organizations are not "commercial type insurance" under IRC Sec. 501(m).

Sincerely,

+ William J. McCormack

Most Reverend William J. McCormack
National Director

Please remember The Society for the Propagation of the Faith
when writing or changing your Will

UCCH

*United Church of Christ Homes*
550 East Main Street
Annville, PA 17003
(717) 867-4467

June 29, 1987

Mr. Robert J. Leonard, Chief Counsel
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Dear Mr. Leonard:

This request is addressed to The Members of the House Ways and Means Committee in reference to the Technical Corrections Act of 1987 (HR 2636).

Following enactment of the Tax Reform Act of 1986, IRC Section 501(m) contained wording which could be misinterpreted to treat charitable gift annuities as "commercial type-insurance". If this should happen, it could mean that charities would be taxed as insurance companies on their gift annuities programs. It is also possible, in certain cases, that charities could lose their non-profit status over this matter.

Charitable gift annuities have been encouraged by the Federal Government through provisions in the Internal Revenue Code for many years. They represent gift instruments, not insurance policies, that enable individuals to make contributions to further causes in which they are interested. Charitable Gift Annuities do not compete with insurance and are not marketed as such. A tax on charitable gift annuities would constitute a tax on philanthropy. It should be noted that charitable gift annuities are particularly popular with smaller donors. Larger donors continue to have access to gift instruments such as Charitable Remainder Trusts which were not affected by the Tax Reform Act of 1986.

On behalf of our organization and the non-profit sector, I respectfully ask the Committee's assistance and support in amending the Technical Corrections Act of 1987 (HR 2636) to clarify that charitable gift annuities issued by IRC Section 501(c)(3) organizations are not "commercial-type insurance".

If HR 2636 is not clarified, I am concerned that a very valuable source of philanthropic support for non-profit organizations will gradually disappear. This certainly would not serve the best interests of society and may result in increased demand for financial support being placed upon the shoulders of government.

Thank you for the Committee's consideration of this request.

Sincerely,

John McFadden

John R. McFadden
Director of Development

United Jewish Appeal-Federation of Jewish Philanthropies of New York, Inc.
130 East 59th Street, New York, N.Y. 10022 (212) 980-1000

Bernard "Bud" Rosner
Director
Endowment Development

July 2, 1987

The Honorable Raymond McGrath
House Office Building
Room 205 Cannon
Washington, DC 20515

Dear Rep. McGrath:

I am writing to you with regard to the Technical Corrections Act of 1987 (H.R. 2636). As someone very much concerned with the charitable sector, I am most concerned about the recently introduced Technical Corrections Act as it relates to IRC Section 501(m) enacted by TRA 1986 and its treatment of charitable gift annuities. I would hope that charitable gift annuities would not be treated as commercial-type insurance so that charities would not be taxed as insurance companies on their gift annuity programs or, in extreme cases, lose their tax exemption all together. I urge you to support an amendment to the Technical Corrections Act of 1987 which would make certain that charitable gift annuities issued by Section 501(c)(3) organizations are not commercial-type insurance.

Let me point out that gift annuities issued by our institutions are used because our supporters want to make a gift to help our institutions and that these gift annuities do not compete with commercial annuities. They are, in reality, gift annuities with charitable intent. For the small donor, a charitable gift annuity is the equivalent of a large donor's charitable remainder annuity trust which is not affected by Section 501(m). It is extremely important that this amendment clarify the law so as to not dry up an important source of funds for organizations such as ours.

We are very hopeful for your support and thank you for your commitment to the philanthropic sector which continues to take the burden from the public and place it on those who can afford to pay the bill.

Sincerely,

Bernard Rosner

We give all the help you can give.

# Statement on Technical Corrections H.R. 2636
IRC Section 501(m)
by Richard D. Bailey, Executive Director
The United Methodist Foundation
in Western North Carolina

## Summary

Neither the Joint Committee's Blue Book explanation of the Tax Reform Act of 1986 or the proposed Technical Correction Act (H.R. 2636) clarified that charitable gift annuities are not subject to IRC Sec. 501(m). Charitable gift annuities are not commercial-type insurance and a technical correction should be made to exempt gift annuities from IRC Sec. 501(m).

## Rationale

Section 501(m) of the 1986 Tax Act says that an organization shall be exempt from taxation only if "no substantial part of its activities consists of providing commercial-type insurance." And, "For purposes of this subsection, the issuance of annuity contracts shall be treated as providing insurance." For organizations that do not lose their exemptions and provide commercial type insurance, the activity will be treated as an unrelated trade or business and taxes on these activities as a life insurance company.

Charitable gift annuities are not commercial-type insurance, and it is clear that the drafters of the subsection did not intend to include them. However, since this question has been raised, a cloud has come over the thousands of charitable institutions that issue gift annuities, among them the Salvation Army and American Bible Society. The Bible Society was the first to issue a gift annuity in 1843, and since then has issued 67,383.

This cloud must be lifted from our charities as quickly as possible. Section 501(m)(3) lists four exemptions. The fifth, "(E) charitable gift annuities" could be added. Or, 501(m)(4) could be amended by inserting the words, "other than charitable gift annuity contracts". It would read:

> (4) Insurance Includes Annuities.--For purpose of this subsection, other than charitable gift annuity contracts, the issuance of annuity contracts shall be treated as providing insurance.

Gift annuities do not compete with commercial annuities and are not "commercial-type insurance". For a small donor, they are equivalent of a large donor's charitable remainder annuity trust, which is not affected by IRC Sec. 501(m).

Please amend H.R. 2636 and clearly exempt the charitable gift annuity from IRC Sec. 501(m).

July 15, 1987

**United Methodist Homes for the Aging of the Wyoming Conference**

*"We care about the people we care for."*

ELIZABETH CHURCH MANOR
865 Front Street
Binghamton, NY 13905
Phone: 607-722-3463

THE METHODIST MANOR
50 W. Tioga Street
Tunkhannock, PA 18657
Phone: 717-836-2983

MURRAY TUFTS GARRETT MANOR
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Beach Lake, PA 18405
Phone: 717-729-7140

GRACE VIEW MANOR
80 Calvary Drive
Norwich, NY 13815
Phone: 607-336-3915

THE HILLTOP CAMPUS
HILLTOP RETIREMENT CENTER
JAMES G. JOHNSTON NURSING HOME
GRAND CARE CENTER
285 Deyo Hill Road
Johnson City, NY 13790
Phone: 607-798-7818

CENTRAL OFFICES
285 Deyo Hill Road
Johnson City, NY 13790
Phone: 607-798-1001

THE WESLEY VILLAGE
MYERS MANOR
PARTRIDGE TIPPETT NURSING FACILITY
NEWING THERAPEUTIC CENTER
Laflin Road
Pittston, PA 18640
Phone: 717-655-2891

June 22, 1987

Robert J. Leonard,
Chief Counsel
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Bldg.
Washington, D.C. 20515

Dear Mr. Leonard:

I am writing regarding the Technical Corrections Act of 1987 (HR 2636). It is my hope and the hope of many middle income donors and their favorite charities that Charitable Gift Annuities be exempted from IRC Section 501(m).

As you may know, Charitable Gift Annuities have been in existence and used by charitable organizations for over 100 years. For the small donor, a Charitable Gift Annuity is the equivalent of a large donors Charitable Remainder Annuity Trust. Incidentally, these Charitable Remainder Annuity Trusts are unaffected by 501(m). Certainly, Charitable Gift Annuities issued by Section 501(c)(3) organizations are not "commercial type annuities".

I might also add for your consideration that there are three life income gift vehicles which are currently sanctioned by the laws of this nation; Pooled Income Funds, Charitable Remainder Trusts, and Charitable Gift Annuities. All three are vehicles for making donations to charities. One of the three life income vehicles should not be inadvertently legislated out of existence. It is disturbing that, after 100 years of use, Congress would declare that routine use of this standard fundraising vehicle would cause either the charities loss of exemption or taxability.

Further, there is a difference between an individual transferring money to Blue Cross/Blue Shield (named in the legislative reports as one of the targets of this legislation) and an individual transferring funds to the Methodist Homes for the Aging. The difference is donative intent; the transferor does not intend to donate money to Blue Cross/Blue Shield but, in fact, buys an insurance policy. The donor to the Methodist Homes for the Aging has the donative intent but an incapacity to part with both principal and income, and for that reason elects to establish a Charitable Gift Annuity.

This is certainly far removed from the purchase of a commercial insurance product. Looking at the transaction from the donor's point of view brings the true nature of the Charitable Gift Annuity into focus. Evidently, the statute looks at this donation from the issuers point of view. In charitable giving both sides must be analyzed together to understand the true nature of the transaction.

Additionally, the Code already contains a detailed test for taxing Charitable Gift Annuities that resemble too closely those annuities offered by commercial agencies. Under Section 5014(c)(5) the unrelated business income tax may apply to a Charitable Gift Annuity that fails certain standards. These detailed tests serve the same function as section 501(m).

I hope that the information presented above may help you in considering this issue. I would be delighted to testify at any hearing regarding this matter.

Please let me know if there is anything else I can do to help the committee decide this issue. Thank you for your thoughtful attention to this matter.

Very truly yours,

David Fanning

David Fanning,
Director of Institutional
Advancement

UMH
THE UNITED METHODIST HOMES OF NEW JERSEY EXECUTIVE OFFICES - 3311 HIGHWAY 33 - P. O. BOX 0887 - NEPTUNE, N. J. 07754-0887 - (201) 922-9800

PRESIDING BISHOP
NEIL L. IRONS
BOARD OF TRUSTEES PRESIDENT
ELIZABETH S. BROGDON
EXECUTIVE DIRECTOR
JACK L. TAYLOR

June 29, 1987

Robert J. Leonard, Chief Counsel
Committee on Ways & Means
Room 1102 Longworth
House Office Building
Washington, D.C. 20515

Dear Mr. Leonard:

As director of development for a federation of nine church-related retirement and nursing homes serving over 1,000 elderly residents annually, I urge you to amend the Technical Corrections Act of 1987 (H.R. 2636) to clarify that charitable gift annuities issued by IRC Sec. 501 (c) (3) organizations are not "commercial-type insurance" under IRC Sec. 501 (m).

Although my responsibilites for The United Methodist Homes of New Jersey are diverse, I have issued 87 charitable gift annuity agreements totalling $446,390 since June 1983 to persons ranging in age from 70 to 97.

Because this volume spreads the actuarial risk, we are able to aply the gift portion of each annuity immediately to our Fellowship Fund, which provides charitable care to 15 - 20% of our residents who can no longer pay for their full costs of care in our homes.

In visiting with our annuitants, I can asssure you that they do not enter into these agreements in order to gain high earnings. When income is a primary consideration, I refer the prospect to a commercial insurance company, where they can invariably obtain higher interest rates. Charitable intent is decidely the primary motivation of our annuitants.

Treating charitable gift annuities as commercial instruments and taxing them accordingly would be an unintended distortion of the 1986 Tax Reform Act. To revoke the 501 (c) (3) status of charities issuing charitable gift annuities would be an act of treachery to the public good.

I implore you to redress this egregious inequity through the General Explanation of the Tax Reform Act and the Technical Corrections Bill.

Thanking you for this valuable consideration, I remain,

Yours truly,

Charles R. Murray

Charles R. Murray
Director of Development
and Public Relations

THE UNIVERSITY OF MARYLAND

*Clearinghouse for Research on Fund Raising*

Mr. Robert J. Leonard, Chief Counsel
House Committee on Ways and Means
1102 Longworth House Office Building
Washington, D.C. 20515
June 26, 1987

Dear Mr. Leonard:

It is my understanding that section 501(m) of the Tax Reform Act of 1986, if passed in its present form, would make charitable gift annuities subject to the unrelated business income tax provisions.

That gift annuity could be considered commercial insurance is beyond belief. Clearly the intent of such an instrument is to provide deferred assistance to a nonprofit organization. The beneficiary is obviously the nonprofit organization since the grantor could merely keep the asset if he/she intended to profit from it.

This legislation must make it clear that gift annuities are not commercial insurance instruments and thus are exempt from the unrelated business income tax. To make such gifts subject to tax would strike a staggering blow to all nonprofit organizations that depend on charitable gifts.

Please share this information with appropriate members of the Committtee.

Cordially,

Robert F. Carbone
Professor and Director

The University of Maryland / 3112 Benjamin Building / College Park, MD 20742
(301) 454-5766

Development Office

UNIVERSITY OF MINNESOTA
TWIN CITIES

College of Education
203b Burton Hall
178 Pillsbury Drive S.E.
Minneapolis, Minnesota 55455-0211

(612) 625-1310

July 1, 1987

Robert J. Leonard
Chief Counsel
House Committee on Ways and Means
1102 Longworth House Office Building
Washington, DC 20515

Dear Mr. Leonard:

I am writing regarding the technical corrections bill covering the 986 Tax Reform Act, which are currently under review by the House Committee on Ways and Means.

The intent of my letter is to clarify that charitable gift annuities are not commercial insurance and therefore should not be subject to the unrelated business income tax. Charitable gift annuities enables a donor to make an immediate gift to a non-profit organization and receive back a specified income for life. Past tax code amendments have never treated charitable gift annuities as an unrelated trade or business.

In reviewing the current bill, it's important to realize that donors use charitable gift annuities because they desire to make a charitable gift, not because they want the annuity income. However, the typical gift annuity donor is often a less wealthy donor and while they generally want to support a charitable organization, they may require the supplemental income the gift annuity provides.

In closing, I wish to state that charitable gift annuities are an important source of contributed income, not business income, to charitable organizations. I ask for your consideration of this fact, so that the corrections bill will clarify the matter in a way which will not subject gift annuities to unrelated business income tax.

Please find enclosed six copies for distribution to the committee members.

Sincerely,

David Madson

David J. Madson
Director of Development

BEST AVAILABLE COPY

**The University of Texas at El Paso**
The Development Office

July 6, 1987

Mr. Robert J. Leonard
Chief Counsel
House Committee on Ways and Means
1102 Longworth House Office Building
Washington, DC 20515

Dear Mr. Leonard:

The University of Texas at El Paso has several retired faculty members who have given Charitable Gift Annuities to this institution over the years. Many of these faculty members have limited income, but their love for the University which provided them an opportunity to teach and serve students was their primary reason for establishing a charitable gift annuity. These donors made an immediate gift to the University and received back a specified income for life, but never expected that their annuities be subject to the unrelated business income tax being considered under Section 501(m) of the Tax Reform Act of 1986.

I hope that you and the House Committee on Ways and Means will clarify that Charitable Gift Annuities are not subject to unrelated business income tax because they are not commercial insurance under Section 501(m) of the Tax Reform Act of 1986.

Sincerely,

James M. Peak
Director of Development

El Paso, Texas 79968-0524 • (915) 747-5533

THE UNIVERSITY OF TULSA
Edwin C. Eanes
Director of Planned Giving and
Estate Planning Services

July 1, 1987

Mr. Robert J. Leonard, Chief Counsel
House Committee on Ways and Means
1102 Longworth House Office Building
Washington, D.C. 20515

Dear Sir:

The technical corrections bill pending in both the House and Senate should consider clarifying that charitable gift annuities are not subject to the unrelated business income tax because they are not commercial insurance, they are primarily charitable gifts. While the law at present does not stipulate otherwise, it could, in the absence of a direct statement, be construed to include charitable gift annuities. It will eliminate a good deal of concern and possible misconception as to the intent of the new section of tax code section 501 (m) if it is clarified.

Sincerely,

Edwin C Eanes

Edwin C. Eanes
Director of Planned Giving
and Estate Planning Services
The University of Tulsa

600 South College Avenue • Tulsa, Oklahoma 74104-3189 • (918) 592-6000

The University of Vermont
OFFICE OF DEVELOPMENT, GRASSE MOUNT
411 MAIN STREET
BURLINGTON, VERMONT 05401
802-656-3275

July 20, 1987

Mr. Robert J. Leonard
Chief Counsel
House Committee on Ways and Means
1102 Longworth House Office Building
Washington, DC 20515

Dear Mr. Leonard:

I understand that public comments have been solicited concerning a proposal to subject charitable gift annuities to unrelated business income tax. I hope that this will not come to pass.

At the University of Vermont, we raise approximately $7 million per year in philanthropic support. A rather small percentage of this money currently comes to us in the form of charitable gift annuities, but this form of giving is popular with our donors and is an option we would be loath to lose. If the current proposal were implemented, we would certainly lose our capacity to accept gifts in this form. The paperwork required to meet the new requirements would be insurmountable in our case.

I'm sure that it is not the intention of the proponents of this bill to weaken our development programs at universities. We do not offer these programs as investments or insurance. They are simply a way of packaging a gift in an attractive way. Since a gift is always involved, our gift annuities would not be attractive investments. They are not investments, and I trust that the committee will recognize this.

Thank you for your attention.

Sincerely,

Robert W. Gibson
Director of Development

**PENN CHARTER**
3000 W. School House Lane • Philadelphia, PA 19144 • 844-3460

Development Office

June 29, 1987

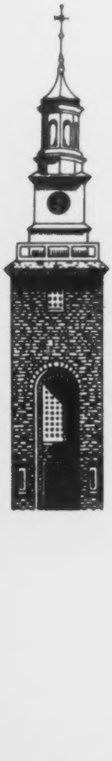
Robert J. Leonard, Esquire
Chief Counsel
House Committee on Ways and Means
United States House of Representatives
1102 Longworth House Office Building
Washington, DC 20515

Dear Mr. Leonard:

I write to you about charitable gift annuities and the need to clarify their status under section 501(m) of the TRA of 1986.

Within the next thirty days, I will be sitting down with an elderly graduate of the William Penn Charter School to discuss how he would like to arrange his support for the School. Without heirs, this 70-year-old gentleman wants to ensure his gift to this School. However, having spent a lifetime in teaching, both in the United States and abroad, he cannot be without income, and a gift annuity will meet his needs and ours very nicely.

But in order to begin to direct his concerns for the welfare of this School, it is necessary for me to have the confidence that I am not creating an insurance product but rather a gift in support of this charitable organization.



Penn Charter was founded in 1689 and chartered three times by William Penn. It is the oldest Quaker School in the world, the fourth oldest School in the United States and the oldest School in Pennsylvania.

Last year, Penn Charter spent $570,000 in financial aid for students and next year financial aid spending will rise to $607,400. When this figure is added to the operating deficit of the School each year, one has an annual challenge of well over $1,200,000 that must be raised either from annual giving or from the income of endowment gifts.

Without the clarification of the intent of Congress not to class charitable gift annuities as unrelated business income subject to taxation, we are unnecessarily burdened in our quest for charitable gifts.

We urge the Ways and Means Committee, when adopting its bill on technical corrections to the 1986 TRA, to clarify — as it has been so in the past — that it was not the intent of the Congress to treat charitable gift annuities as if they were a commercial insurance activity. They are not. I am a development professional, not an insurance executive. My efforts are devoted to raising charitable gifts for the William Penn Charter School, not to sell insurance. The difference is critical both for me and those middle class men and women I turn to in my quest for funds.

Respectfully yours,

Wm. D. Ravdin
Director of Development

Section 1012-- Similar letters were also received from the following (not printed but retained in Committee files):

- Air Force Village Foundation, San Antonio, Tex., Omar Pitman, letter
- Albertus Magnus College, New Haven, Conn., Julia M. McNamara, O.P., letter
- Albright College, Reading, Pa., Patricia N. Moulton, letter
- All Saints' Episcopal Church, Beverly Hills, Calif., M. Gregory Richards, Rector, statement
- America's Keswick, Whiting, N.J., William E. Bibik, letter
- American Baptist Churches, Ministers and Missionaries Benefit Board, New York, N.Y., Dear R. Wright, letter
- American Baptist Foreign Mission Society, Valley Forge, Pa., William E. Jarvis, letter
- American Diabetes Association, Oklahoma Affiliate, Inc., Tulsa, Okla., Ann Richards Ketcham, letter
- American Heart Association, Iowa Affiliate, Mrs. Vicki Kimes, letter
- American Leprosy Missions, Elmwood Park, N.J., Eugene L. Wilson, letter
- AMG International, Chattanooga, Tenn., Otto A. Anderson, letter
- Andrews University, Berrien Springs, Mich., Oliver L. Johnston, letter
- Anne Carlsen School, Jamestown, N.D., Henry Edwards, letter
- Arkansas Baptist Foundation, Little Rock, Ark., Harry D. Trulove, letter and attachment
- Art Center College of Design, Pasadena, Calif., Warren B. Knox, letter
- Auburn Alumni Association, Auburn University, Ala., Jerry F. Smith, letter
- Augustana College, Rock Island, Ill., James D. Horstmann, letter
- Austin College, Sherman, Tex.:
  - William R. McLeRoy, letter
  - J. Thomas Stewart, letter
- B'Nai B'Rith Foundation of the U.S., Sidney H. Closter, letter
- Baldwin-Wallace College, Berea, Ohio, Thomas H. Konkoly, letter
- Bangor, Maine, Theological Seminary, Susan L. Grove-Markwood, letter
- Baptist Bible College & Theological Seminary, Clarks Summit, Pa., Milo Thompson, Jr., letter
- Baptist Foundation of Oklahoma, Oklahoma City, Okla., Robert L. Ross, W.G. Kersh, and C. Duane Riley, joint letter
- Baptist Health Services Foundation, Gadsden, Ala., George P. Gray, Jr., letter
- Baptist Hospital Fund, Midway and Mounds Park Hospitals, St. Paul, Minn., James B. Field, letter
- Barlow, Argus S., Brevard, N.C., letter
- Bates College, Lewiston, Maine, Eugene G. Taylor, letter
- Baylor University Medical Center Foundation, Dallas, Tex., Dan T. Garrett, letter
- Bellevue College Foundation, Bellevue, Neb., Patricia J. Morocco, letter
- Berea College, Berea, Ky., Lou S. Lakes, letter
- Bethany College, Lindsborg, Kansas, R. Jay Ribble, and Donald E. Trued, letters
- Bethphage Mission, Inc., Omaha, Neb., David A. Jacox, letter
- Bible Literature International, Columbus, Ohio, James R. Falkenberg, President
- Biola University, La Mirada, Calif., Gary R. Boren, letter
- Blair Academy, Blairstorn, N.J., Mary C. Tychonievich, letter
- Bongard, Diane, Cincinnati, Ohio, letter
- Bowling Green State University, Bowling Green, Ohio, Dwight F. Burlingame, and John H. Fogel, letters
- Boys Club of Fort Worth, Tex., Tracey Brown, letter
- Bradley University, Peoria, Ill., Ian T. Sturrock, letter
- Brebeuf Preparatory School, Indianapolis, Ind., M. Joseph Casey, S.J., letter
- Bremwood Lutheran Children's Home Society, Waverly, Iowa, Harold Hunter, letter
- Brevard College, Brevard, N.C., Mark A. Bailey, letter

Brockport College of the State University of New York, Patric S. Madama, letter
Bryan College, Dayton, Tenn., Kenneth G. Hanna, letter
Buckner Baptist Benevolences, San Antonio, Tex., Michael Nealeigh, letter
Buena Vista College, Storm Lake, Iowa, J. Robert Siefer, letter
Bush School, Seattle, Wash., John R. Corkran, letter
Calhoun School, New York, N.Y., Marilyn Stuart, letter
California Luthern University, Thousand Oaks, Calif., Jerry H. Miller, letter
California State Polytechnic University, Pomona, Calif., Reginald E. Kirven, letter
California State University, Dominguez Hills, Carson, Calif., Kenneth W. Finlay, letter
California State Polytechnic University, Pomona, Calif., Reginald E. Kirven, letter
Callahan, Timothy A.R., Birmingham, Ala., letter
Calumet College, Whiting, Ind., Father Ronald J. Schiml, C.PP.S., letter
Calvin College and Seminary, Grand Rapids, Mich., John Heerspink, letter
Campbellsville, Ky., College, Kenneth H. Pope, letter
Canton, Ohio, Christian Home, Larry Burgett, letter
Capper Foundation, Topeka, Kansas, Edward F. Gibbons, and Monty E. Nelson, joint letter
Carle Foundation, Urbana, Ill., W. Frank Elston, letter
Carlisle Group, Carlisle, Pa., George W. Bahner, letter
Case Western Reserve University, Frances Payne Bolton School of Nursing, Cleveland, Ohio, Sandra Deller, letter
Catholic Archdiocese of Seattle, Wash., Steve Kocharhook, letter
Catholic Chancery, Diocese of Kansas City-St. Joseph, Mo., Dennis Putthoff, letter
Catholic Charities of the Archdiocese of Dubuque, Iowa, James L. Yeast, letter
Catholic Foundation, Dallas, Tex., Hal F. Tehan, letter
Catholic Missions Office, Diocese of Joliet, Ill., Rev. John P. Driscoll, letter
Cedarville, College, Cedarville, Ohio, Martin E. Clark, and Robert K. Rohm, letters
Center for Creative Studies, Detroit, Mich., Dennis E. Moore, letter
Chaddock, Quincy, Ill., Marge Ozley
Cheyenne Mountain Zoological Park, Colorado Springs, Colo., Karen Murray, letter
Chicago School of Professional Psychology, Kathleen Slomski, letter
Chicago Lung Association, John L. Kirkwood, letter
Chicago School of Professional Psychology, Kathleen Slomski, letter
Child Evangelism Fellowship Inc., Warrenton, Mo., Paul E. Blackburn, statement
Children's Hospital, Phoenix, Ariz., Barbara L. Grier, letter
Children's Hospital Foundation, Denver, Colo., Herman J. West, letter
Children's Hospital National Medical Center, Washington, D.C., Terry L. Lierman, and Thomas D. Walsh, joint letter
Children's Mercy Hospital, Kansas City, Mo., Lawrence A. McAndrews, letter
Christian Appalachian Project, Lancaster, Ky., William A. Begley, letter
Christian Church in the Upper Midwest, Des Moines, Iowa, James S. Kratz, letter
Christian Record Braille Foundation, Inc., Lincoln, Neb., Vernon L. Bretsch, letter
Christian Reformed Home Missions, Grand Rapids, Mich., R. Jack De Vos, letter
Church of Jesus Christ of Latter-Day Saints, Ron S. Taylor, letter
Cincinnati, Ohio, Country Day School, William H. Hopple, III, letter

City of Hope, Cincinnati, Ohio, Herbert E. Ostrov, Ruth J. Preston, Mary Bridget Reilly, and Diane Bongard, letters
Claremont School of Theology, Claremont, Calif., David H. Nienas, letter
Clark University, Worcester, Mass., Rilchard P. Traina, letter
Clarke College, Dubuque, Iowa, Catherin Dunn, and Therese Mackin, letters
College of Du Page, Glen Ellyn, Ill., D. Richard Petrizzo, letter
College of Idaho, Caldwell, Idaho, W. Michael Born, letter
College of Mount St. Joseph on the Ohio, Cincinnati, Ohio, Mary Declan Browne, letter
College of New Rochelle, N.Y., Sister Dorothy Ann Kelly, O.S.U., letter
College of Saint Rose, Albany, N.Y., John C. Barner, letter
College of St. Francis, Jolliet, Ill., Stephen F. Stauffenberg, letter
College of Wooster, Ohio, Grace M. Tompos, letter
Colgate University, Campaign for Colgate, Hamilton, N.Y., Donald F. Martin, letter
Columbia College, Columbia, South Carolina, Robert T. Barham, letter
Columbia College, Columbia, Mo., Ralph E. Glenn, letter
Columbian Fathers, St. Columbans, Neb., Rev. John M. Lagomarsino, letter and attachment
Community Counselling Service Co., Inc., Western Division, San Francisco, Calif., Michael A. DeNunzio, letter
Concordia College, Moorhead, Minn., David M. Benson, letter
Concordia College, Ann Arbor, Mich., Thomas A. Fitchett, letter
Concordia College, Bronxville, N.Y., Hans G. Springer, letter
Concordia College of St. Paul, Minn., Michael D. Flynn, letter
Conservative Baptist Foundation of Arizona, Phoenix, Ariz., Paul G. Spears, letter
Corcoran School of Art, Washington, D.C., Sally J. Smith, letter
Cornell College, Mount Vernon, Iowa, David Marker, letter
Corpus Christi, Texas, Diocese of, Rev. Randy Majek, letter
Council on Health & Human Services, Wisconsin Conference/United Church of Christ, Dennis Streiff, letter
Culver Educational Foundation, Culver, Ind., Channing E. Mitzell, letter
Cumberland Presbyterian Church, Board of Finance, Foundation and Management, Memphis, Tenn., Don Alexander, letter
Dakota Wesleyan University, Mitchell, S.D., Stan Haidle, letter
De Moines, Iowa, Diocese of, Nancy Perazelli, letter
Deaconess Foundation, Cleveland, Ohio, Susan Ell, letter
Denison Unviversity, Granville, Ohio, J. Leslie Hicks, Jr., letter
Denver Conservative Baptist Seminary, Denver, Colorado, Donald D. Orvis, letter
Dickinson College, Carlisle, Pa., A. Lee Fritschler, letter
Dominick, Frank, Dominick, Fletcher, Yeilding, Wood & Lloyd, Birmingham, Ala., letter
Donald A. Campbell & Company, Inc., Chicago, Ill., Thomas G. Sanberg, letter
Drew University, Madison, N.J., Steven Kavanaugh, letter
Drexel Hill, Pa., School of the Holy Child, Sr. Barbara Foy, SHCJ, letter
Drexel University, Philadelphia, Pa., Carolyn A. Sprogell, letter
Drury College, Springfield, Mass., Kathy S. Evans, letter
Dubuque, Iowa, Archdiocese of, Fr. John J. O'Connor, letter
Eagle Village, Inc., Hersey, Mich., Willard P. Hedberg, letter
East Carolina University, Greenville, N.C., Micah D. Ball, letter
Eastern College, Eastern Baptist Theological Seminary, St. Davids, Pa., William R. Rueckle, letter
Eastern Mennonite High School, Harrisonburg, Va., Les Helmuth, letter
Elyria, Ohio, United Methodist Home, Charles V. Watt, letter
Episcopal Church Center, New York, N.Y., Frederick Osborn III, letter
Episcopal High School, Alexandria, Va., Nathaniel H. Acker, letter
Erie Diocesan Mission Office, Father Daniel J. Kresinski, letter

Eureka College, Eureka, Ill., George A. Hearne, letter
Evangelical Covenant Church, Chicago, Ill., LeRoy M. Johnson, letter
Evangelical Free Church of America, Minneapolis, Minn., Gene Jones, letter
Evangelistic Faith Missions, Bedford, Ind., Rev. J.B. "Juddie" Peyton, letter
Fairfield, Conn., University, James E. Reilly, letter
Family Service Detroit and Wayne County, Mich., Mary Jane Michaels, letter
Fay School, Southborough, Mass., Martin Haley, letter
FCNL Education Fund, Washington, D.C., Edward F. Snyder, letter
Fellowship of Reconciliation, Nyack, N.Y., John Horn, letter
Florida Institute of Technology, Melbourne, Fla., Keener Smathers, letter
Florida Presbyterian Homes, Inc., Lakeland, Fla., Daniel D. Dickenson, letter
Florida State University Foundation, Tallahassee, Fla., Paula S. Fortunas, letter
Florida United Methodist Children's Home, Enterprise, Fla., Charles H. Goodrich, letter
Fort Sanders Foundation, Knoxville, Tenn., Paul G. Alexander, letter
Four County Mental Health Services, Inc., St. Charles, Mo., Karl Wilson, and Jill Ditchik, joint letter
Fox Chase Cancer Center, Philadelphia, Pa., Sandra W. Weckesser, letter
Frantzreb, Arthur C., Arthur C. Frantzreb, Inc., McLean, Va., letter
Freed-Hardeman College, Henderson, Tenn., E. Claude Gardner, letter
Freedom from Hunger Foundation, Davis, Calif., John Logan, letter
Friends of Israel Gospel Ministry, Inc., Bellmawr, N.J., William E. Sutter, Fred Bartman, Marvin J. Rosenthal, and William C. Varner, joint letter
Friends of Mercy, Springfield, Ohio, John E. Pickarski, letter
Geisinger Foundation, Danville, Pa., H.W. Wieder, Jr., letter
General Conference Auditing Service, Washington, D.C., O. Richard Caldwell, letter
Georgia Baptist Foundation, Inc., Atlanta, Ga., Donald L. Folsom, letter
Georgian Court College, Lakewood, N.J., Sister Barbara Williams, letter
Georgetown College, Georgetown, Ky., J. Richard Carlton, letter
Girl Scouts, Plymouth Bay Girl Scout Council, Inc., Taunton, mass., Robert A. Lewis, letter
Gonzaga University, Spokane, Wash., Jane Orr, letter
Good Samaritan Society, Sioux Falls, S.D., Raymond L. Mehl, and Randy Fitzgerald, joint letter
Goodman, Woodrow, Upland, Calif., letter
Goodwill Industries of Pittsburgh, Goodwill Industries of Fayette County, Uniontown, Pa., and Goodwill Plaza, Inc., Pittsburgh, Pa., Donna M. DeBlasis, letter
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Harding University, Searcy, Ark., C. Alvin Fowler, letter
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Harker Academy, San Jose, Calif., Susan C. Covey, letter
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Haverford School, Haverford, Pa., Murray Dodge, letter
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James Madison University, Harrisonburg, Va., Don R. Moore, II, letter
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Lancaster, Pa., Community Hospital of, Elizabeth A. Kauffman, letter
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Lasell Junior College, Newton, Mass., John McDonagh, letter

Lee Holthaus & Associates, Wheaton, Ill., Lee Holthaus, letter
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Lincoln Memorial University, Harrogate, Tenn., Gary J. Burchett, letter
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Mennonite Brethren Churches Board of Trustees, Hillsboro, Kansas, Marvin L. Reimer, letter
Middlebury College, the Campaign for, Middlebury, Vt., David E. Thompson, letter
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National Rehabilitation Hospital, Washington, D.C., Edward A. Eckenhoff, letter
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Ohio Northern University, Ada, Ohio, Gregory C. Bobonich, letter
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Paoli Memorial Hospital, Paoli, Pa., A. Sidney Williams, letter
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Piedmont Technical College Foundation, Greenwood, S.C., Ernest W. Prewett, Jr., letter
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Pittsburg State University, Pittsburg, Kansas, Donald C. Widner, letter
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Queen of the Valley Foundation, West Covina, Calif., John M. Tincher, letter
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Randolph-Macon Woman's College, Lynchburg, Va., James C. Kughn, Jr., letter
Rappahannock Community College Educational Foundation, Inc., Warsaw, Va., Patricia A. Nicholas, letter
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  Illinois, Canton Citadel Corps, Captain Kjell Steinsland, letter
  Illinois, Decatur, Captain John L. Mallett, letter
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- Science of Mind Foundation, Los Angeles, Calif., William M. Lynn, letter
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- Seventh-day Adventists:
  - Atlantic Union Conference, South Lancaster, Mass., Dale R. Beaulieu, letter
  - Columbia Union Conference Association, Harvey L. Sauder, letter
  - General Conference, Washington, D.C., Wyman S. Wager, letter
  - Idaho Conference, Boise, Idaho, Southern Idaho Corp., Leon Cornforth, letter
  - Iowa-Missouri Conference, West Des Moines, Iowa, Harvey J. Byran, letter
  - Kansas-Nebraska Conference, Topeka, Kansas, Joel Thompkins, letter
  - Michigan Conference Association, Lansing, Mich., Ralph Trecartin, letter
  - New York Conference Association, Syracuse, N.Y., W. Robert Daum, letter
  - Northern New England Conference, Portland, Maine, Terry McCormick, letter
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  - Southwestern Union Conference, Southwest Estate Services, Inc., Charles F. O'Dell, letter
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  - Western Washington Corporation, Bothell, Washington, I.E. Burke, letter
- Sharp Hospitals Foundation, San Diego, Calif., Phyllis A. Allen, letter
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- Sioux Falls College, Soux Falls, S.D., Leon Bill, letter
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- Society for the Propagation of the Faith:
  - Baltimore, Md., Myrtle B. Stanley, Archdiocesan Director, letter
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  - Cleveland, Ohio, Rev. Ralph E. Wiatrowski, Diocesan Director pro tem, letter
  - Merrillville, Ind., Rev. J. Patrick Gaza, Diocesan Director, letter
  - Oakland, Calif., Rev. Gary B. Tollner, Diocesan Director, letter
  - Rockville Centre, N.Y., Msgr. Lawrence F. Ballweg, Diocesan Director, letter
  - Saginaw, Mich., Diocese of, Rick Nix, Mission Office, letter
  - San Antonio, Tex., Sr. Evangeline Escobar, F.M.I., Archdiocesan Director, letter
  - Seattle, Wash., Barbara Geraci, Archdiocesan Director, letter
- Society of Automotive Engineers, Inc., Warrendale, Pa., James W. Cunningham, letter
- Somerset Medical Center, Somerville, N.J., John L. Galloway, letter
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- South Iowa Methodist Homes, Des Moines, Iowa, John F. Courter, letter

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  United Church Board for World Ministries, New York, N.Y., Myles H. Walburn, letter
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United Methodist Church Foundation, Inc., Syracuse, N.Y., V. Stewart Underwood, letter
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United Way Endowment/Planned Giving Program, Santa Barbara, Calif., Sally C. Walker, letter

University of Akron, Ohio, John B. Shorrock, letter
University of Alabama, Tuscaloosa, Ala., Don L. Atkins, letter
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University of Arizona Foundation, Tucson, Ariz., Kenneth A. Haber, letter
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University of Baffalo Foundation, Inc., Buffalo, N.Y., Joseph J. Mansfield, letter
University of Chicago, School of Social Service Administration, Chicago, Ill., Mary Jane Keitel, letter
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University of Northern Iowa Foundation, Cedar Falls, Iowa, Dee Vandeventer, letter
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University of Tennessee at Chattanooga, Ronald G. Area, letter
University of the South, Sewane, Tenn., Tom G. Watson, letter
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Valley Baptist Medical Foundation, Harlingen, Tex., F. Joe Snyder, letter
Valparaiso University, Valparaiso, Ind., Robert V. Schnabel, letter
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Vasser College, Poughkeepsie, N.Y., Sue Peirce Hartshorn, letter
Vernon Advent Christian Home, Inc., Vernon, Vt., Raymond M. Beecroft, letter
Villa Maria Academy, Malvern, Pa., Sister Regina Stephen Lavan, letter
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Virginia Polytechnic Institute and State University, Blacksburg, Va., W.E. Lavery, letter
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Wesley Foundation, Wichita, Kansas, Frank M. Burch, letter
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Western Maryland College, Westminster, Md., H. Hugh Dawkins, Jr., letter
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Westover School, Middlebury, Conn., Cortlandt B. Fengler, letter
Wheaton College, Norton, Mass., Debra Ashton, letter
Wheeling Country Day School, Wheeling, W. Va., Richard E. Kammer, Headmaster, letter
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Whitworth Foundation, Whitworth College, Spokane, Wash., Stephen Trefts, letter
Wilkes College, Wilkes-Barre, Pa., Richard F. Charles, letter
Willard Library of Evansville, Ind., Martin L. Leich, letter
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Winchester-Thurston School, Pittsburgh, Pa., Helen G. Scully, letter
Wittenberg University, Springfield, Ohio, William A. Kinnison, letter
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Worcester, Diocese of, Worcester, Mass., Most Rev. Timothy J. Harrington, letter

Word of Life Fellowship, Inc., Schroon Lake, N.Y., Douglas H. Mieras, letter
World Radio Missionary Fellowship, Inc., Opa Locka, Fla., Dwite M. McCloud, letter
YMCA of Metropolitan Chicago, Ill., Marcus T. Young, letter
York Hospital, York, Pa., H. Charles Hafey, Jr., letter
Young Men's Christian Association of Metropolitan Detroit, Mich., Kenneth C. Isherwood, letter
Zenko, John A., Chicago, Ill., letter

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June 25, 1987

Robert J. Leonard
Chief Counsel
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, DC 20515

Re: Technical Correction to I.R.C. §832(b)(4) -- to Eliminate a Double Disallowance of Deduction for Certain Acquisition Expenses

Dear Mr. Leonard:

We are submitting the attached document on behalf of CNA Insurance Companies, Chicago, IL. The document briefly describes a technical problem presented by the 20-percent adjustment to unearned premiums in I.R.C. §832(b)(4) that was adopted by Congress in the Tax Reform Act of 1986.

We believe that CNA is one of just four companies that follow the holding in Western Casualty and Surety Company v. Commissioner, 571 F.2d 514 (10th Cir. 1978) and do not deduct commissions relating to deferred premium installments when the policy is issued, although such installments are reflected in unearned premiums. The Western Casualty method of accounting combined with the recently adopted 20-percent adjustment to unearned premiums causes a double adjustment for these acquisition expenses.

Please consider this letter as written comments on H.R. 2636, submitted to the Ways and Means Committee for its formal consideration.

Sincerely,

Susan J. Hotine

Susan J. Hotine

**DRAFT**

## Technical Correction to I.R.C. §832(b)(4) Eliminate a Double Disallowance of Deduction for Certain Acquisition Expenses

### Background

The Tax Reform Act of 1986 amended I.R.C. §832(b)(4) to provide a better matching of premium income and expenses associated with the earning of that income. Under the provision, a property/casualty insurance company generally is required to reduce its deduction for increases in unearned premiums by 20 percent. The 20-percent adjustment is intended to represent the allocable portion of expenses incurred in generating the unearned premiums. The reduction of the current deduction for unearned premiums provides a better matching because it "is equivalent to denying current deductibility for a portion of the premium acquisition expenses" -- that portion attributable to the unearned premiums (see the General Explanation of the Tax Reform Act of 1986 (1986 Blue Book), prepared by the staff of the Joint Committee on Taxation, p. 595 (May 4, 1987)).

In adopting the 20-percent adjustment to unearned premiums, Congress did statutorily what some courts had begun already. Specifically, in Western Casualty and Surety Company v. Commissioner, 571 F.2d 514 (10th Cir. 1978), 78-1 USTC ¶9220, the court denied the taxpayer a deduction for unpaid sales commissions on deferred premium installments in the year the policies were issued, even though the taxpayer showed the commissions on its annual statement as expenses incurred and reflected the deferred premium installments as part of its unearned premiums. There was a similar holding in City Investing Company v. Commissioner, 52 T.C.M. 1422 (1987). The 20-percent adjustment provides a broader range of income and expense matching, reaching not only commissions relating to deferred premium installments, but other acquisition expenses such as paid commissions and premium taxes.

### The Problem

The 20-percent adjustment to unearned premiums represents the portion of expenses incurred that is allocable to generating the unearned premiums, including sales commissions on deferred premium installments. To have this adjustment combined with a direct disallowance of a current deduction for such expenses (the Western Casualty method of accounting) results in a double disallowance of a current deduction (or a double adjustment).

To our knowledge there are no more than four companies which are using the "Western Casualty method of accounting" for commissions relating to deferred premium installments -- that is, not deducting those commissions when the policy is issued. It would be unfair to disadvantage the few companies that have acquiesced in following the Western Casualty decision.

### Proposed Technical Correction

The 20-percent adjustment to unearned premiums should be reduced by the amount of any sales commissions/expenses directly disallowed by the application of the Western Casualty method of accounting.

Revenue Discussion

The legislative history of the provision adopting a 20-percent adjustment to unearned premiums indicates that Congress assumed that all premium acquisition expenses, including commissions attributable to unearned premiums, were included in "expenses incurred" and deductible currently. See H. Rep. 99-426, 99th Cong., 1st Sess. 668 et seq. (1985); S. Rep. 99-313, 99th Cong., 2d Sess. 495 et seq. (1986); the 1986 Blue Book, pp. 594 et seq. In fact, with the exception of only a few companies, this assumption was true.

By reducing the unearned premium deduction (and accelerating the recognition of premium income), the 20-percent adjustment was intended to result in a better matching of income and expenses. There was general recognition that the reduction of unearned premiums is equivalent to denying current deductibility for a portion of the premium acquisition expenses -- that is, the portion attributable to unearned premiums.

The overall revenue estimate for the property/casualty industry would not have assumed a double disallowance of a current deduction for commissions relating to such deferred premium installments. Thus, the proposed technical correction should be revenue neutral. Or, in the alternative, because there are only a few (four to our knowledge) companies that use a Western Casualty method of accounting, the revenue for the proposed technical correction to the 20-percent adjustment provision should be de minimis.

Section 1023

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HAND DELIVERED

July 17, 1987

Robert J. Leonard, Esquire
Chief Counsel
Committee on Ways and Means
1102 Longworth House Office Building
Washington, D.C. 20515

Dear Mr. Leonard:

The effects of recent changes in the taxation of property and casualty insurance companies have worked an unintended hardship on primarily small nonprofit hospital-owned or sponsored malpractice insurers. These companies were created by groups of nonprofit hospitals to self insure themselves and their staffs when commercial insurance became unaffordable or unobtainable. These companies were apparently unrepresented when the insurance provisions were negotiated with the major commercial carriers last year. The provisions of the Act would result, in many cases, in fiscal 1987 tax liability which actually approaches or exceeds the annual taxable income of these companies. Such a result seems totally adverse to established principals of taxation. For this reason, I would hope some transition relief could be included in technical corrections legislation this year.

Enclosed are comments reflecting the views of these insurers and suggesting possible transition alternatives which recognize the revenue constraints of the Committee. I would appreciate it if these comments could be considered by the Committee and its staff in addressing these issues during the mark-up of technical corrections legislation.

I would welcome the opportunity to discuss this issue in greater detail or to answer any questions. Please have your staff contact Marc J. Scheineson at (202)857-4498 if we may be of additional assistance.

Best regards.

Sincerely,

Frank N. Ikard

Frank N. Ikard

FINLEY, KUMBLE, WAGNER, HEINE,
UNDERBERG, MANLEY, MYERSON & CASEY

# COMMENTS BY COALITION OF INSURERS OF NON-PROFIT HOSPITALS TO THE COMMITTEE ON WAYS & MEANS ON THE TECHNICAL CORRECTIONS ACT OF 1987

## 1. Background

The Tax Reform Act of 1986 revised the taxation of property-casualty insurance companies. The principal impact of the changes came through discounting of loss reserves for federal income tax purposes, even though companies continued to carry full value reserves for state regulatory purposes. This provision, which is estimated to generate $4.2 billion in tax revenues over 5 years, falls principally upon the lines of business requiring the longest time to settle claims--medical malpractice, general liability, and worker's compensation. For these "long-tail" lines, the difference between the discounted reserve deduction for federal income tax purposes and the full value reserve established for state regulatory accounting purposes, is substantial. For non-profit hospital medical malpractice coverage written by coalition members, the estimated discount based on the industry aggregates adopted by the Treasury in Rev. Rul. 87-34 amounts to 24% of the increase in their reserves. Accordingly, for this group of insurers the amount of the deduction allowed for increases in loss reserves has been reduced on average by approximately 24%.

## 2. Insurers of Non-Profit Hospitals Severely Impacted by New Law

There are 31 insurance companies, subject to the Act, which are either hospital-owned or hospital-sponsored which provide medical malpractice coverage for primarily non-profit hospitals. These companies are organized in various forms including trusts, tax-exempt associations, or as taxable corporations. These companies were formed by hospitals to provide their malpractice and general liability coverage were begun after the medical malpractice crisis of 1975, and include two companies recently formed as a result of the liability crisis of 1985-86. They were formed primarily to assure the availability of malpractice insurance to hospitals at the lowest reasonable cost.

The companies are organized primarily as stock insurance companies with insured hospitals or hospital trade associations as their shareholders. They include reinsurers as well as primary insurers; mutuals and reciprocal insurers in a few instances; and their insureds include a very small number of for-profit hospitals, as well. These 31 hospital owned or sponsored companies now provide approximately 70% of the malpractice coverage for non-profit hospitals in this country.

Insurers of non-profit hospitals are especially hard-hit by the new discounting provisions. The coverage they provide to hospitals is predominately the lines most affected by discounting--medical malpractice, and, smaller amounts of general liability. According to a survey of these companies, they expect to pay an additional $46.5 million in taxes on reserves of $1.8 billion for 1987, despite the fresh start adjustment. Over a 5 year period, assuming a 12.5% rate of growth for 1988 and later years, the additional tax attributable to discounting would amount to more than $137.6 million. The calculation of these additional taxes is illustrated in the chart on the following page.

## CHART A

Estimated Revenue Effect of Loss Discounting Rules
(based on survey estimates of 31% growth of loss reserve
for 1987 and projected 12.5% rate of annual growth
of loss reserves thereafter)

(all figures in thousands of dollars)

| | 1987 | 1988 | 1989 | 1990 | 1991 |
|---|---|---|---|---|---|
| Estimated loss reserve @ year end | 1,834,911 | 2,064,275 | 2,322,309 | 2,612,598 | 2,939,173 |
| Discounted reserves (@ 76%) | 1,389,504 | 1,563,192 | 1,758,591 | 1,978,415 | 2,225,717 |
| Loss reserve discount | 445,407 | 501,083 | 563,718 | 634,183 | 713,456 |
| Less prior year loss reserve discount (including fresh start) | 329,223 | 445,407 | 501,083 | 563,718 | 634,183 |
| Increase in taxable income | 116,184 | 55,676 | 62,635 | 70,465 | 79,273 |
| Tax rate | 40% | 34% | 34% | 34% | 34% |
| Tax effect | 46,473 | 18,930 | 21,296 | 23,958 | 26,953 |

### 3. Non-Profit Hospital Insurers Must Increase Premiums Dramatically to Pay the Additional Taxes

Unlike large multi-line commercial insurers, which monitored the tax proposals closely and lobbied actively during Congressional consideration of the new provisions, these smaller companies did not appreciate the new law's impact until they reviewed their estimated tax projections this spring. They do not have substantial net operating loss carryforwards to shelter their taxable income during the Act's initial years, as do many multi-line commercial carriers. The substantial additional costs imposed by the new tax law must be passed along to the hospitals with a minimum of delay. These companies, writing medical malpractice insurance for primarily non-profit hospitals, are on the horns of a dilemma of either dramatic rate increases or substantial reductions of coverage--neither of these is acceptable to the non-profit hospitals which are their stockholders and insureds.

### 4. The Harsh Impact of The New Law Should Be Modified

These companies are willing to pay their fair share of taxes. The burden of the 1986 changes, however, falls disproportionately on long-tail lines. It is not spread evenly across all property-casualty insurers. For example, for one of these companies, MMI Companies, Inc. of Bannockburn, Illinois, the changes in the Act could result in estimated 1987 federal income tax liability of $5.6 million on estimated statutory consolidated net income of $6.9 million. That result could occur despite the use of a $7.7 million NOL carryforward in 1987. This 81% tax rate in 1987 is confiscatory and inconsistent with established tax policy.

Daniel J. McNamara, President of the Insurance Services Office ("ISO"), a not-for-profit service organization that provides advisory rating, research, and statistical information to property-casualty insurers, commented on the concentration of the tax burden on long-tail lines in an address this January:

> While the impact of the new tax law may be small for all lines combined, a new ISO study indicates that the impact is large for each of three long-tail commercial casualty lines of insurance that we analyzed--general liability, workers compensation, and medical malpractice.
>
> Our study focused on the first-year impact of the Tax Reform Act, and compared the bottom-line results under the new and old tax laws against various scenarios of underwriting results. The results of our study are sobering.
>
> For general liability insurance, we studied scenarios based on 1987 combined ratios [a standard industry measurement of all premium income to all expenses] ranging from 100 to 120. Our conclusion -- the combined ratios under the new tax law must be six to eleven points lower than required under the old tax law to produce the same after-tax earnings for this line of insurance. The higher the combined ratio, the greater the impact of the new legislation. . .
>
> For medical malpractice insurance, we studied an ever wider range of combined ratios--115 to 155. Under the new tax law, the combined ratio must be twelve to twenty-two points lower to produce the same after tax earnings as before.
>
> Because of our study's sobering results, ISO subjected its methodology, quantitative analysis, assumptions and conclusions to independent outside review by Coopers & Lybrand. The tax and actuarial partners of that organization have confirmed that validity of our methodology and analysis and concur in the reasonableness of our assumptions as well as results.
>
> Speech before the Annual Meeting, January 13, 1987.

### 5. Proposed Modification: Delay Imposition of the Discounting Rules for 2 Years

The intent of Congress in revising the property-casualty insurance provisions was to ensure that commercial carriers, which had historically paid a very low rate of tax, assumed their fair share of taxes. The impact of discounting, however, was not fully appreciated when the Act was passed. Revenues are not being raised equally from all companies and their policyholders. Unfortunately, the effect of the Act varies widely depending upon the lines of business written. The disproportionate impact of the new provisions upon long-tail lines has meant that non-profit hospitals, which formed these specialized insurers to guarantee that coverage would be available and affordable, now face dramatic rate increases or reductions of coverage.

To prevent unanticipated increases in medical malpractice insurance, and to allow Congress to fully assess the impact of the new law on insurers and policyholders, particularly non-profit hospitals, we request that the specialized insurers providing medical malpractice and other coverage to non-profit hospitals be granted a two-year delay in imposition of the discounting rules of the 1986 Act. This deferral will prevent non-profit hospitals from bearing a disproportionate share of the costs associated with restructuring the taxation of property-casualty insurers. This will also allow these specialized insurers to submit material to the Treasury Department for consideration in its study of the loss reserve discounting rules due in January, 1989.

## 6. Revenue Impact

We estimate that these 31 companies will hold approximately $1.8 billion in reserves for 1987. A two year delay, according to our best estimates, would result in a revenue loss of $46.3 million in 1987, and $18.9 million in 1988, or a total of $65.4 million for the two years. (see Chart B)

Given the pressures on all hospitals to reduce costs, we believe this deferral is a sensible means to alleviate the unanticipated and unintended harsh impact of the Act upon non-profit hospital insurers.

### CHART B

REVENUE EFFECT OF TWO-YEAR DELAY TO
JANUARY 1, 1989 IN EFFECTIVE DATE OF
LOSS DISCOUNTING RULES WITH CHANGE
OF FRESH START DATE TO
DECEMBER 31, 1988
(all dollar amounts in thousands)

Note: The following projections incorporate the total revenue effect for hospital-formed companies writing medical malpractice insurance for primarily non-profit hospitals. The estimated revenue loss drops between 1987 and 1988 because of the reduction of the corporate tax rate from 40% to 34%, and a slower projected rate of growth of loss reserves.

| | | 12.5% growth assumption |
|---|---|---|
| Estimated revenue effect | 1987 | ($46,473) |
| | 1988 | ( 18,930) |
| | 1989 | -- |
| | 1990 | -- |
| | 1991 | -- |
| Total for period | | ($65,403) |

## Amendment to Technical Corrections Act for Non-Profit Hospital Insurers

1. Background: The Tax Reform Act of 1986 revised the taxation of property-casualty insurers. The largest single change occurred in discounting the loss reserves of insurers for federal income tax purposes, an item expected to produce $4.2 billion of revenue over a 5 year period.

2. Impact of Discounting Falls Primarily on Long-Tail Lines Such as Medical Malpractice: The intent of Congress in revising the property-casualty insurance provisions was to ensure that commercial carriers, which had historically paid a very low rate of tax, assumed their fair share of taxes. The impact of discounting, however, on certain important smaller companies which sell only a few lines of long-tail insurance was not fully appreciated when the Act was passed. Revenues are not being raised equally from all companies. The effect of the Act varies widely depending upon the lines of business written, severely impacting companies which write exclusively long-tail lines.

3. Insurers of Non-Profit Hospitals Must Increase Premiums Dramatically to Pay the Additional Taxes: Unlike large commercial insurers, which had the resources to monitor the tax proposals closely and lobbied actively during Congress's considerations of the new provisions, these smaller companies did not appreciate the new law's impact until they reviewed their estimated tax projections this spring. They do not have substantial net operating loss carryforwards to shelter their taxable income during the Act's initial years, as do many commercial carriers. Unlike multi-line insurers, they cannot spread the new taxes across all lines of business equally. The additional taxes must be passed along to the hospitals without delay.

4. The Harsh Impact of the Law Should Be Modified: To prevent unanticipated increases in medical malpractice insurance for non-profit hospitals, we request that the specialized insurers providing medical malpractice and other coverage to non-profit hospitals should be granted a two-year delay in imposition of the discounting rules of the '86 Act. This deferral will prevent non-profit hospitals from bearing a disproportionate share of the costs associated with restructuring the taxation of property-casualty insurers.

5. Revenue Impact: We estimated that the 31 companies which were hospital owned or sponsored and provided medical malpractice coverage for primarily non-profit hospitals will hold approximately $1.8 billion in reserves for 1987. A two year delay would result in a revenue loss of $46.3 million in 1987, and $18.9 million in 1988, or a total of $65.4 million for the two years.

# WRITTEN STATEMENT OF EDWARD H. BUDD
# CHAIRMAN AND CHIEF EXECUTIVE OFFICER
# OF THE TRAVELERS CORPORATION

My name is Edward H. Budd and I am the Chairman and Chief Executive Officer of The Travelers Corporation, a multi-line insurance and financial services institution. This written statement is being submitted concerning H.R. 2636, The Technical Corrections Act of 1987, pursuant to the press release of Chairman Dan Rostenkowski dated June 10, 1987.

This statement concerns a substantial inequity with respect to the Tax Reform Act of 1986 ("1986 Act") which I believe should be corrected through an amendment to H.R. 2636. Specifically, this inequity relates to the transition rules regarding the implementation of the discounting rules applicable to property and casualty insurance companies. These rules are referred to as the "fresh start rules."

The enacted version of the fresh start rules treats otherwise identically situated property and casualty insurance companies differently, depending on whether or not a company previously discounted loss reserves as now mandated for all companies by the 1986 Act. Quite unfairly, the company that previously discounted reserves as did the Travelers receives less fresh start benefit than the company which is only now beginning to discount. The competitive concerns associated with this inequitable treatment are apparent. Attached to this statement is an illustration of the inequity and statutory language that would address it (Attachment A).

I am well aware that revenue concerns represent a major factor which must be considered in assessing the merits of technical corrections legislation. While I believe that the fairness aspects of this matter independently justify addressing this matter in H.R. 2636 without regard to revenue considerations, I also believe that the proposed amendment properly should be treated as having no revenue effect. I reach this conclusion because I believe the proposed amendment would conform the statute to the method of estimating the cost of the fresh start benefit at the time of the enactment of the 1986 Act. Attached to this statement is a memorandum which discusses this point in more detail (Attachment B).

I am informed that the analysis of the revenue cost of the proposed amendment set forth in the attached memorandum is consistent with the approach the Joint Committee on Taxation took in estimating a conceptually comparable provision include in H.R. 2636. Specifically, section 105(a)(10) of H.R. 2636 indicates that post-1986 installment sales income attributable to pre-1987 sales of passive loss type activities will be treated as passive income for purposes of offsetting passive losses under section 469 of the IRC. This provision of H.R. 2636 specifically reverses the published position of the Internal Revenue Service on this matter. It is my understanding that the Joint Committee on Taxation has taken the position that section 105(a)(10) of H.R. 2636 has no revenue effect because the change will conform the statute to the assumption under which the Joint Committee on Taxation originally estimated the revenue effect of the passive loss rules. I believe this situation is conceptually identical to the situation concerning the proposed amendment because the amendment would conform the statute to the assumptions under which the Joint Committee on Taxation originally estimated the revenue effect of the fresh start rules.

I very much appreciate the considered attention of the Committee on Ways and Means to this important matter.

ATTACHMENT A

## TAX REFORM ACT OF 1986
## PROPERTY AND CASUALTY INSURANCE RESERVES:
## FRESH START TRANSITIONAL RULES

Tax Reform Act of 1986 -- Sec. 1023. Section 1023 of the Act (section 846 of the Code), relating to the taxation of property and casualty insurance companies, requires these companies to discount their loss reserves for the first time. As a part of this provision, section 1023(e)(3) provided a so-called "fresh start" rule. The purpose of the "fresh start" rule was to allow insurers to start the year 1987 on the new, discounted basis for their loss reserves without taking into account any differences between the old and new bases for purposes of determining their taxable income.

Problem. This fresh start rule determines the new base by applying the new tax reserve discount factor to the "undiscounted annual statement reserve."

Thus, this rule provides a different amount of "fresh start" depending solely upon whether or not a company has been discounting its reserves on its annual statement. In other words, two insurance companies with identical liabilities will receive a different fresh start benefit if one company has been discounting such reserves on its annual statement ("A/S"), and the other company has not. The company that has been discounting such reserves will receive a smaller fresh start amount than the other company. This result is inequitable.

Solution. This inequity could be substantially corrected by applying the tax reserve discount rate to the "annual statement reserve" (line 2 below) rather than the "undiscounted annual statement reserve" (line 1 below). This approach would result in substantial equity between Company A and Company B.

Illustration.

| | | Company A | Company B |
|---|---|---|---|
| 1. | Undiscounted A/S Reserve | 100 | 100 |
| 2. | A/S Reserve | 100 | 95 (disc.) |
| 3. | Fresh Start Rule: | | |
| | Old Basis (line 2) | 100 | 95 |
| | New Basis (line 1) x (.93, assumed tax discount rate) | 93 | 93 |
| | Fresh Start Amount | 7 | 2 |
| 4. | Proposed Fresh Start Rule: | | |
| | Old Basis (line 2) | 100 | 95 |
| | New Basis (line 2 x .93) | 93 | 88.35 |
| | Fresh Start Amount | 7 | 6.65 |

### Statutory Draft

This proposed fresh start transition rule might be implemented by amending section 1023 of The Tax Reform Act of 1986 as follows:

SEC.___. AMENDMENT RELATED TO SECTION 1023 OF THE ACT.

Paragraph 2 of section 1023(e) of the Tax Reform Act of 1986 (relating to transition rules) is amended by adding at the end thereof the following new sentence:

> "For purposes of the preceding sentence, with respect to workers' compensation, such unpaid losses shall be determined without application of paragraph (2) of section 846(b) of such Code (as added by this section) where such losses were shown on the annual statement on a discounted basis."

ATTACHMENT B

July 10, 1987

## MEMORANDUM

## ANALYSIS OF PROPER ESTIMATING CONVENTION FOR TRANSITION RULE INTENDED TO CONFORM FRESH START BENEFIT FOR PRE-1986 DISCOUNTED RESERVES

### I. Background

The Tax Reform Act of 1986 ("1986 Act") for the first time requires property and casualty insurance companies to discount unpaid losses and certain unpaid expenses. Section 1023 of the 1986 Act and section 846 of the IRC. This provision is generally applicable to taxable years after December 31, 1986. Section 1023(e)(1). Application of the discounting provisions to existing reserves is governed by section 1023(e)(2). It provides that opening reserves on January 1, 1987, are to be calculated as if the discounting provisions of the 1986 Act originally had been applicable to the losses and expenses related to these reserves. The provision is similar to a comparable provision provided in the Deficit Reduction Act of 1984 related to a modification of the reserve deductions allowed for life insurance companies. The effect of this provision is to provide a double deduction of the amount equal to the difference between undiscounted expenses and losses and the discounted expenses and losses (the "fresh start benefit"). Under section 1023(e)(3), the fresh start benefit is not to be taken into account for purposes of the Internal Revenue Code of 1986. The fresh start benefit for a property and casualty insurance company generally is equal to the difference between the undiscounted reserves and the discounted reserves. For example, if a company had an undiscounted reserve of $100 on December 31, 1986, effective January 1, 1987, such reserve would be restated as if it had been discounted originally, i.e., at $93. In this case, the amount of the fresh start benefit is $7.

Prior to the 1986 Act, almost all property and casualty companies did not discount unpaid losses or unpaid expenses. A small minority of companies already had begun discounting of such reserves prior to the 1986 Act. For those companies, the application of the fresh start rules will provide a smaller benefit than for those companies that had not been discounting reserves. For example, if in the example discussed above the company had discounted its $100 reserve to $95 prior to the 1986 Act, the amount of the fresh start benefit would only be $2 (i.e., the difference between $93 and $95).

### II. Proposed Conforming Transition Rule

The operation of the fresh start rule under section 1023(e) unfairly discriminates in favor of those companies that had not discounted reserves prior to the 1986 Act while penalizing companies that already had been discounting reserves. It is suggested that a proper method of addressing this discriminatory aspect is to provide a conforming transition rule which would provide companies that had been discounting reserves prior to the 1986 Act with treatment comparable to that of companies that had not discounted reserves.

## III. Proper Estimating Convention for Transition Rule to Conform Fresh Start Benefit.

### A. . Overview.

In considering the proposed transition rule, a relevant factor will be, what, if any revenue effect should be attributable to it. The purpose of this memo is to suggest that the transition rule proposed should be treated as having no revenue effect. There are two possible ways in which the fresh start benefit originally could have been estimated. Under either approach, it is believed that the inclusion of the proposed transition rule would not have affected the revenue estimate and, therefore, should be treated as having no revenue effect if implemented as part of technical correction legislation. The two possible methods of originally estimating the fresh start provision are discussed below along with the basis for concluding that the proposed transition rule should be viewed as having no revenue effect as part of technical corrections legislation.

### B. Estimate of Transition Rule Assuming that the Fresh Start Benefit was not Originally Taken Into Account in Computing Discounting Provisions.

It is possible that the estimate of the discounting provisions of the 1986 Act did not take into account the fresh start aspect of these rules. No publicly released documents indicate that the fresh start benefit was taken into account. If this is the case, the inclusion of the proposed technical correction transition rule would have had no impact on the estimate of the impact of the discounting provisions nor would it have had an impact on the overall estimate of the provisions affecting the property and casualty industry. If this is the case, inclusion of the technical correction transition rule as part of the technical corrections process also should be viewed as having no revenue effect.

### C. Effect of Proposed Transition Rule Assuming that the Fresh Start Provisions were Taken into Account in Estimating the Discounting Provision.

In the alternative, the method used to estimate the discounting provisions may have assumed some loss of revenue attributable to the fresh start benefit. Given the small minority of companies which were actually discounting reserves prior to the 1986 Act, however, it is unlikely that any assumption was made as to the effect which the discounting of those reserves prior to the 1986 Act had on the effect of the fresh start benefit. That is, it is assumed that the fresh start benefit was calculated assuming that no companies were discounting reserves prior to the 1986 Act. As a consequence, the inclusion of the proposed technical transition rule to provide all companies with the same fresh start benefit without regard to whether they were discounting reserves prior to the 1986 Act would have had no impact on the validity of the initial revenue estimate. As a result, the inclusion of the proposed technical transition rule as part of the technical corrections legislation also should be viewed as having no revenue impact.

Section 1031

**FINLEY, KUMBLE, WAGNER, HEINE**
**UNDERBERG, MANLEY, MYERSON & CASEY**

## COMMENTS CONCERNING PROPOSED MUTUAL PROTECTION TRUST TECHNICAL CORRECTION FOR INCLUSION IN TECHNICAL CORRECTIONS ACT OF 1987

The attached language corrects three potential problems created by Section 1031(a) of the Tax Reform Act of 1986 and Section 110(g) of H.R. 2636, the "Technical Corrections Act of 1987" (the "Act"). This statement is submitted on behalf of the Mutual Protection Trust by its Washington, D.C. legislative counsel, Finley, Kumble, Wagner, Heine, Underberg, Manley, Myerson & Casey.

1. Applies to Tax Treatment of Entity and not Members. The Act revised only paragraph (a)(1) of §1031 which addresses the treatment of the deductible initial contributions as income to the qualifying organization. It should be clearly stated that this change also applies for purposes of determining the deductibility of such payments by the members as provided in paragraph (a)(2).

2. Installment Payment Language Requires Modification. The Act refers to "annual installments." In practice, the Mutual Protection Trust allows quarterly payments of the annual installments of initial trust contributions (see attached schedule of installment payment plans). Therefore, to conform to existing practice, the language should be revised to eliminate the reference to annual installments and to require only that all installments be made within six years.

3. Deductibility for Subsequent Contributions is Required. Under current California law, an eligible organization's trust fund corpus is established with the initial trust contribution payments required from members upon admission. These payments are deductible to members under the provisions of §1031(a). Current California law also authorizes increases in such trust fund corpus where necessary in the best interests of the organization (and if permitted by the terms of the organization's trust agreement) through additional trust contributions by existing members.

The Mutual Protection Trust believes that the California Legislature may soon mandate such additional trust fund corpus payments from existing members, or the Mutual Protection Trust may amend its trust agreement to require such increases. The words "any initial payment" in §1031(a) could be construed to limit the deduction of trust corpus payments only to those made as part of the initial membership process. To assure that §1031(a) will apply to future contributions by existing members to increase the trust fund corpus, it is suggested that the words "any initial payment" be replaced by "any contribution to the capital of the association or to the corpus of the trust."

This revision remains consistent with the original intent of §1031(a) that payments to physicians interindemnity arrangements receive tax treatment equal to, and not more favorable than, that provided for premium payments to an independent insurance company for similar annual insurance coverage. There is no possibility that this revision could be used for any abusive tax purpose since no payments to the organization in excess of the cost of comparable insurance coverage are deductible under existing §1031(a).

If you have any questions or if further information is required, please contact Peter N. Kyros at 857-4693 or Marc J. Scheineson at 857-4498.

## SUGGESTED LANGUAGE FOR INCLUSION IN TECHNICAL CORRECTIONS ACT OF 1987

### SEC. 1031. PHYSICIANS' AND SURGEONS' MUTUAL PROTECTION AND INTERINDEMNITY ARRANGEMENTS OR ASSOCIATIONS.

SEC. 110 of the Technical Corrections Act of 1987 is amended to read as follows:

> (g) **AMENDMENT RELATED TO SECTION 1031 OF THE REFORM ACT** - Paragraph (1) of section 1031(a) of the Reform Act are amended by omitting "any initial payment" in Subparagraph (A) and inserting in lieu thereof "any contribution to the capital of the association or to the corpus of the trust, whether made in a lump sum or in installments over not more than six years," and by omitting "initial payment" and inserting in lieu thereof "contribution." Paragraph (2) is amended by omitting "any initial payment" in Subparagraph (A) and inserting in lieu thereof "any contribution as described in paragraph (1)," and by omitting "initial payment" or "payment" appearing throughout and inserting in lieu thereof "contribution."

Payment #1 due upon acceptance. All other payments are due on a quarterly basis.

## GROUP PAYMENT PLAN

**CLASS 1 — $4,000.00**

| 12 Payment Plan | 7½% Charge | Trust Deposit | Total Payment |
|---|---|---|---|
| Payment 1 | $ -0- | $ 368.42 | $ 368.42 |
| Payment 2 | 68.08 | 300.34 | 368.42 |
| Payment 3 | 62.45 | 305.97 | 368.42 |
| Payment 4 | 56.71 | 311.71 | 368.42 |
| Payment 5 | 50.86 | 317.56 | 368.42 |
| Payment 6 | 44.92 | 323.50 | 368.42 |
| Payment 7 | 38.85 | 329.57 | 368.42 |
| Payment 8 | 32.67 | 335.75 | 368.42 |
| Payment 9 | 26.37 | 342.05 | 368.42 |
| Payment 10 | 19.96 | 348.46 | 368.42 |
| Payment 11 | 13.42 | 355.00 | 368.42 |
| Payment 12 | 6.75 | 361.67 | 368.42 |
| Total | $421.04 | $4,000.00 | $4,421.04 |

| 16 Payment Plan | 7½% Charge | Trust Deposit | Total Payment |
|---|---|---|---|
| Payment 1 | $ -0- | $ 286.32 | $ 286.32 |
| Payment 2 | 69.63 | 216.69 | 286.32 |
| Payment 3 | 65.57 | 220.75 | 286.32 |
| Payment 4 | 61.42 | 224.90 | 286.32 |
| Payment 5 | 57.21 | 229.11 | 286.32 |
| Payment 6 | 52.92 | 233.40 | 286.32 |
| Payment 7 | 48.53 | 237.79 | 286.32 |
| Payment 8 | 44.08 | 242.24 | 286.32 |
| Payment 9 | 39.53 | 246.79 | 286.32 |
| Payment 10 | 34.91 | 251.41 | 286.32 |
| Payment 11 | 30.20 | 256.12 | 286.32 |
| Payment 12 | 25.39 | 260.93 | 286.32 |
| Payment 13 | 20.50 | 265.82 | 286.32 |
| Payment 14 | 15.52 | 270.80 | 286.32 |
| Payment 15 | 10.43 | 275.89 | 286.32 |
| Payment 16 | 5.28 | 281.04 | 286.32 |
| Total | $581.12 | $4,000.00 | $4,581.12 |

| 20 Payment Plan | 7½% Charge | Trust Deposit | Total Payment |
|---|---|---|---|
| Payment 1 | $ -0- | $ 237.24 | $ 237.24 |
| Payment 2 | 70.56 | 166.68 | 237.24 |
| Payment 3 | 67.43 | 169.81 | 237.24 |
| Payment 4 | 64.25 | 172.99 | 237.24 |
| Payment 5 | 61.00 | 176.24 | 237.24 |
| Payment 6 | 57.70 | 179.54 | 237.24 |
| Payment 7 | 54.33 | 182.91 | 237.24 |
| Payment 8 | 50.90 | 186.34 | 237.24 |
| Payment 9 | 47.41 | 189.83 | 237.24 |
| Payment 10 | 43.85 | 193.39 | 237.24 |
| Payment 11 | 40.22 | 197.02 | 237.24 |
| Payment 12 | 36.52 | 200.72 | 237.24 |
| Payment 13 | 32.76 | 204.48 | 237.24 |
| Payment 14 | 28.93 | 208.31 | 237.24 |
| Payment 15 | 25.02 | 212.22 | 237.24 |
| Payment 16 | 21.05 | 216.19 | 237.24 |
| Payment 17 | 16.99 | 220.25 | 237.24 |
| Payment 18 | 12.86 | 224.38 | 237.24 |
| Payment 19 | 8.65 | 228.59 | 237.24 |
| Payment 20 | 4.37 | 232.87 | 237.24 |
| Total | $744.80 | $4,000.00 | $4,744.80 |

Payment #1 due upon acceptance. All other payments are due on a quarterly basis.

### CLASS 2 — $7,000.00

| 12 Payment Plan | 7½% Charge | Trust Deposit | Total Payment |
|---|---|---|---|
| Payment 1 | $ -0- | $ 644.74 | $ 644.74 |
| Payment 2 | 119.15 | 525.59 | 644.74 |
| Payment 3 | 109.29 | 535.45 | 644.74 |
| Payment 4 | 99.25 | 545.49 | 644.74 |
| Payment 5 | 89.02 | 555.72 | 644.74 |
| Payment 6 | 78.60 | 566.14 | 644.74 |
| Payment 7 | 67.99 | 576.75 | 644.74 |
| Payment 8 | 57.14 | 587.60 | 644.74 |
| Payment 9 | 46.15 | 598.59 | 644.74 |
| Payment 10 | 34.95 | 609.79 | 644.74 |
| Payment 11 | 23.50 | 621.24 | 644.74 |
| Payment 12 | 11.84 | 632.90 | 644.74 |
| Total | $ 736.88 | $7,000.00 | $7,736.88 |

| 16 Payment Plan | 7½% Charge | Trust Deposit | Total Payment |
|---|---|---|---|
| Payment 1 | $ -0- | $ 501.06 | $ 501.06 |
| Payment 2 | 121.85 | 379.21 | 501.06 |
| Payment 3 | 114.74 | 386.32 | 501.06 |
| Payment 4 | 107.49 | 393.57 | 501.06 |
| Payment 5 | 100.13 | 400.93 | 501.06 |
| Payment 6 | 92.59 | 408.47 | 501.06 |
| Payment 7 | 84.94 | 416.12 | 501.06 |
| Payment 8 | 77.14 | 423.92 | 501.06 |
| Payment 9 | 69.19 | 431.87 | 501.06 |
| Payment 10 | 61.09 | 439.97 | 501.06 |
| Payment 11 | 52.85 | 448.21 | 501.06 |
| Payment 12 | 44.44 | 456.62 | 501.06 |
| Payment 13 | 35.88 | 465.18 | 501.06 |
| Payment 14 | 27.15 | 473.91 | 501.06 |
| Payment 15 | 18.26 | 482.80 | 501.06 |
| Payment 16 | 9.22 | 491.84 | 501.06 |
| Total | $1,016.96 | $7,000.00 | $8,016.96 |

| 20 Payment Plan | 7½% Charge | Trust Deposit | Total Payment |
|---|---|---|---|
| Payment 1 | $ -0- | $ 415.17 | $ 415.17 |
| Payment 2 | 123.48 | 291.69 | 415.17 |
| Payment 3 | 118.01 | 297.16 | 415.17 |
| Payment 4 | 112.43 | 302.74 | 415.17 |
| Payment 5 | 106.75 | 308.42 | 415.17 |
| Payment 6 | 100.97 | 314.20 | 415.17 |
| Payment 7 | 95.07 | 320.10 | 415.17 |
| Payment 8 | 89.07 | 326.10 | 415.17 |
| Payment 9 | 82.97 | 332.20 | 415.17 |
| Payment 10 | 76.74 | 338.43 | 415.17 |
| Payment 11 | 70.39 | 344.78 | 415.17 |
| Payment 12 | 63.92 | 351.25 | 415.17 |
| Payment 13 | 57.34 | 357.83 | 415.17 |
| Payment 14 | 50.64 | 364.53 | 415.17 |
| Payment 15 | 43.79 | 371.38 | 415.17 |
| Payment 16 | 36.84 | 378.33 | 415.17 |
| Payment 17 | 29.73 | 385.44 | 415.17 |
| Payment 18 | 22.50 | 392.67 | 415.17 |
| Payment 19 | 15.13 | 400.04 | 415.17 |
| Payment 20 | 7.63 | 407.54 | 415.17 |
| Total | $1,303.40 | $7,000.00 | $8,303.40 |

Payment #1 due upon acceptance. All other payments are due on a quarterly basis.

**CLASS 3 — $10,000.00**

| 12 Payment Plan | 7½% Charge | Trust Deposit | Total Payment |
|---|---|---|---|
| Payment 1 | $ -0- | $ 921.06 | $ 921.06 |
| Payment 2 | 170.22 | 750.84 | 921.06 |
| Payment 3 | 156.13 | 764.93 | 921.06 |
| Payment 4 | 141.80 | 779.26 | 921.06 |
| Payment 5 | 127.17 | 793.89 | 921.06 |
| Payment 6 | 112.30 | 808.76 | 921.06 |
| Payment 7 | 97.13 | 823.93 | 921.06 |
| Payment 8 | 81.71 | 839.35 | 921.06 |
| Payment 9 | 65.94 | 855.12 | 921.06 |
| Payment 10 | 49.93 | 871.13 | 921.06 |
| Payment 11 | 33.59 | 887.47 | 921.06 |
| Payment 12 | 16.80 | 904.26 | 921.06 |
| Total | $1,052.72 | $10,000.00 | $11,052.72 |

| 16 Payment Plan | 7½% Charge | Trust Deposit | Total Payment |
|---|---|---|---|
| Payment 1 | $ -0- | $ 715.81 | $ 715.81 |
| Payment 2 | 174.08 | 541.73 | 715.81 |
| Payment 3 | 163.91 | 551.90 | 715.81 |
| Payment 4 | 153.57 | 562.24 | 715.81 |
| Payment 5 | 143.03 | 572.78 | 715.81 |
| Payment 6 | 132.28 | 583.53 | 715.81 |
| Payment 7 | 121.34 | 594.47 | 715.81 |
| Payment 8 | 110.20 | 605.61 | 715.81 |
| Payment 9 | 98.84 | 616.97 | 715.81 |
| Payment 10 | 87.29 | 628.52 | 715.81 |
| Payment 11 | 75.50 | 640.31 | 715.81 |
| Payment 12 | 63.49 | 652.32 | 715.81 |
| Payment 13 | 51.26 | 664.55 | 715.81 |
| Payment 14 | 38.80 | 677.01 | 715.81 |
| Payment 15 | 26.11 | 689.70 | 715.81 |
| Payment 16 | 13.26 | 702.55 | 715.81 |
| Total | $1,452.96 | $10,000.00 | $11,452.96 |

| 20 Payment Plan | 7½% Charge | Trust Deposit | Total Payment |
|---|---|---|---|
| Payment 1 | $ -0- | $ 593.10 | $ 593.10 |
| Payment 2 | 176.38 | 416.72 | 593.10 |
| Payment 3 | 168.57 | 424.53 | 593.10 |
| Payment 4 | 160.60 | 432.50 | 593.10 |
| Payment 5 | 152.50 | 440.60 | 593.10 |
| Payment 6 | 144.23 | 448.87 | 593.10 |
| Payment 7 | 135.82 | 457.28 | 593.10 |
| Payment 8 | 127.24 | 465.86 | 593.10 |
| Payment 9 | 118.51 | 474.59 | 593.10 |
| Payment 10 | 109.61 | 483.49 | 593.10 |
| Payment 11 | 100.55 | 492.55 | 593.10 |
| Payment 12 | 91.32 | 501.78 | 593.10 |
| Payment 13 | 81.91 | 511.19 | 593.10 |
| Payment 14 | 72.33 | 520.77 | 593.10 |
| Payment 15 | 62.56 | 530.54 | 593.10 |
| Payment 16 | 52.61 | 540.49 | 593.10 |
| Payment 17 | 42.48 | 550.62 | 593.10 |
| Payment 18 | 32.15 | 560.95 | 593.10 |
| Payment 19 | 21.64 | 571.46 | 593.10 |
| Payment 20 | 10.99 | 582.11 | 593.10 |
| Total | $1,862.00 | $10,000.00 | $11,862.00 |

Payment #1 due upon acceptance. All other payments are due on a quarterly basis.

**CLASS 4 — $13,000.00**

| 12 Payment Plan | 7½% Charge | Trust Deposit | Total Payment |
|---|---|---|---|
| Payment 1 | $ -0- | $ 1,197.37 | $ 1,197.37 |
| Payment 2 | 221.27 | 976.10 | 1,197.37 |
| Payment 3 | 202.97 | 994.40 | 1,197.37 |
| Payment 4 | 184.32 | 1,013.05 | 1,197.37 |
| Payment 5 | 165.32 | 1,032.05 | 1,197.37 |
| Payment 6 | 145.97 | 1,051.40 | 1,197.37 |
| Payment 7 | 126.27 | 1,071.10 | 1,197.37 |
| Payment 8 | 106.21 | 1,091.16 | 1,197.37 |
| Payment 9 | 85.72 | 1,111.65 | 1,197.37 |
| Payment 10 | 64.90 | 1,132.47 | 1,197.37 |
| Payment 11 | 43.67 | 1,153.70 | 1,197.37 |
| Payment 12 | 21.82 | 1,175.55 | 1,197.37 |
| Total | $1,368.44 | $13,000.00 | $14,368.44 |

| 16 Payment Plan | 7½% Charge | Trust Deposit | Total Payment |
|---|---|---|---|
| Payment 1 | $ -0- | $ 930.55 | $ 930.55 |
| Payment 2 | 226.30 | 704.25 | 930.55 |
| Payment 3 | 213.09 | 717.46 | 930.55 |
| Payment 4 | 199.64 | 730.91 | 930.55 |
| Payment 5 | 185.94 | 744.61 | 930.55 |
| Payment 6 | 171.97 | 758.58 | 930.55 |
| Payment 7 | 157.75 | 772.80 | 930.55 |
| Payment 8 | 143.26 | 787.29 | 930.55 |
| Payment 9 | 128.50 | 802.05 | 930.55 |
| Payment 10 | 113.46 | 817.09 | 930.55 |
| Payment 11 | 98.14 | 832.41 | 930.55 |
| Payment 12 | 91.53 | 848.02 | 930.55 |
| Payment 13 | 66.63 | 863.92 | 930.55 |
| Payment 14 | 50.43 | 880.12 | 930.55 |
| Payment 15 | 33.93 | 896.62 | 930.55 |
| Payment 16 | 17.23 | 913.32 | 930.55 |
| Total | $1,888.80 | $13,000.00 | $14,888.80 |

| 20 Payment Plan | 7½% Charge | Trust Deposit | Total Payment |
|---|---|---|---|
| Payment 1 | $ -0- | $ 771.03 | $ 771.03 |
| Payment 2 | 229.30 | 541.73 | 771.03 |
| Payment 3 | 219.14 | 551.89 | 771.03 |
| Payment 4 | 208.79 | 562.24 | 771.03 |
| Payment 5 | 198.25 | 572.78 | 771.03 |
| Payment 6 | 187.51 | 583.52 | 771.03 |
| Payment 7 | 176.57 | 594.46 | 771.03 |
| Payment 8 | 165.42 | 605.61 | 771.03 |
| Payment 9 | 154.07 | 616.96 | 771.03 |
| Payment 10 | 142.50 | 628.53 | 771.03 |
| Payment 11 | 130.71 | 640.32 | 771.03 |
| Payment 12 | 118.71 | 652.32 | 771.03 |
| Payment 13 | 106.48 | 664.55 | 771.03 |
| Payment 14 | 94.02 | 677.01 | 771.03 |
| Payment 15 | 81.32 | 689.71 | 771.03 |
| Payment 16 | 68.39 | 702.64 | 771.03 |
| Payment 17 | 55.22 | 715.81 | 771.03 |
| Payment 18 | 41.79 | 729.24 | 771.03 |
| Payment 19 | 28.13 | 742.90 | 771.03 |
| Payment 20 | 14.28 | 756.75 | 771.03 |
| Total | $2,420.60 | $13,000.00 | $15,420.60 |

Payment #1 due upon acceptance. All other payments are due on a quarterly basis.

**CLASS 5 — $16,000.00**

| 12 Payment Plan | 7½% Charge | Trust Deposit | Total Payment |
|---|---|---|---|
| Payment 1 | $ -0- | $ 1,473.69 | $ 1,473.69 |
| Payment 2 | 272.33 | 1,201.36 | 1,473.69 |
| Payment 3 | 249.81 | 1,223.88 | 1,473.69 |
| Payment 4 | 226.85 | 1,246.84 | 1,473.69 |
| Payment 5 | 203.47 | 1,270.22 | 1,473.69 |
| Payment 6 | 179.67 | 1,294.02 | 1,473.69 |
| Payment 7 | 155.39 | 1,318.30 | 1,473.69 |
| Payment 8 | 130.69 | 1,343.00 | 1,473.69 |
| Payment 9 | 105.51 | 1,368.18 | 1,473.69 |
| Payment 10 | 79.85 | 1,393.84 | 1,473.69 |
| Payment 11 | 53.71 | 1,419.98 | 1,473.69 |
| Payment 12 | 27.00 | 1,446.69 | 1,473.69 |
| Total | $1,684.28 | $16,000.00 | $17,684.28 |

| 16 Payment Plan | 7½% Charge | Trust Deposit | Total Payment |
|---|---|---|---|
| Payment 1 | $ -0- | $ 1,145.29 | $ 1,145.29 |
| Payment 2 | 278.53 | 866.76 | 1,145.29 |
| Payment 3 | 262.27 | 883.02 | 1,145.29 |
| Payment 4 | 245.71 | 899.58 | 1,145.29 |
| Payment 5 | 228.85 | 916.44 | 1,145.29 |
| Payment 6 | 211.67 | 933.62 | 1,145.29 |
| Payment 7 | 194.15 | 951.14 | 1,145.29 |
| Payment 8 | 176.33 | 968.96 | 1,145.29 |
| Payment 9 | 158.15 | 987.14 | 1,145.29 |
| Payment 10 | 139.65 | 1,005.64 | 1,145.29 |
| Payment 11 | 120.79 | 1,024.50 | 1,145.29 |
| Payment 12 | 101.57 | 1,043.72 | 1,145.29 |
| Payment 13 | 82.01 | 1,063.28 | 1,145.29 |
| Payment 14 | 62.07 | 1,083.22 | 1,145.29 |
| Payment 15 | 41.75 | 1,103.54 | 1,145.29 |
| Payment 16 | 21.14 | 1,124.15 | 1,145.29 |
| Total | $2,324.64 | $16,000.00 | $18,324.64 |

| 20 Payment Plan | 7½% Charge | Trust Deposit | Total Payment |
|---|---|---|---|
| Payment 1 | $ -0- | $ 948.96 | $ 948.96 |
| Payment 2 | 282.22 | 666.74 | 948.96 |
| Payment 3 | 269.72 | 679.24 | 948.96 |
| Payment 4 | 256.98 | 691.98 | 948.96 |
| Payment 5 | 244.00 | 704.96 | 948.96 |
| Payment 6 | 230.78 | 718.18 | 948.96 |
| Payment 7 | 217.32 | 731.64 | 948.96 |
| Payment 8 | 203.60 | 745.36 | 948.96 |
| Payment 9 | 189.62 | 759.34 | 948.96 |
| Payment 10 | 175.38 | 773.58 | 948.96 |
| Payment 11 | 160.90 | 788.06 | 948.96 |
| Payment 12 | 146.10 | 802.86 | 948.96 |
| Payment 13 | 131.06 | 817.90 | 948.96 |
| Payment 14 | 115.72 | 833.24 | 948.96 |
| Payment 15 | 100.10 | 848.86 | 948.96 |
| Payment 16 | 84.20 | 864.76 | 948.96 |
| Payment 17 | 67.96 | 881.00 | 948.96 |
| Payment 18 | 51.44 | 897.52 | 948.96 |
| Payment 19 | 34.62 | 914.34 | 948.96 |
| Payment 20 | 17.48 | 931.48 | 948.96 |
| Total | $2,979.20 | $16,000.00 | $18,979.20 |

Payment #1 due upon acceptance. All other payments are due on a quarterly basis.

**CLASS 6 — $19,000.00**

| 12 Payment Plan | 7½% Charge | Trust Deposit | Total Payment |
|---|---|---|---|
| Payment 1 | $ -0- | $ 1,750.01 | $ 1,750.01 |
| Payment 2 | 323.38 | 1,426.63 | 1,750.01 |
| Payment 3 | 296.63 | 1,453.38 | 1,750.01 |
| Payment 4 | 269.39 | 1,480.62 | 1,750.01 |
| Payment 5 | 241.62 | 1,508.39 | 1,750.01 |
| Payment 6 | 213.34 | 1,536.67 | 1,750.01 |
| Payment 7 | 184.53 | 1,565.48 | 1,750.01 |
| Payment 8 | 155.18 | 1,594.83 | 1,750.01 |
| Payment 9 | 125.28 | 1,624.73 | 1,750.01 |
| Payment 10 | 94.82 | 1,655.19 | 1,750.01 |
| Payment 11 | 63.79 | 1,686.22 | 1,750.01 |
| Payment 12 | 32.16 | 1,717.85 | 1,750.01 |
| Total | $2,000.12 | $19,000.00 | $21,000.12 |

| 16 Payment Plan | 7½% Charge | Trust Deposit | Total Payment |
|---|---|---|---|
| Payment 1 | $ -0- | $ 1,360.04 | $ 1,360.04 |
| Payment 2 | 330.75 | 1,029.29 | 1,360.04 |
| Payment 3 | 311.45 | 1,048.59 | 1,360.04 |
| Payment 4 | 291.79 | 1,068.25 | 1,360.04 |
| Payment 5 | 271.76 | 1,088.28 | 1,360.04 |
| Payment 6 | 251.35 | 1,108.69 | 1,360.04 |
| Payment 7 | 230.56 | 1,129.48 | 1,360.04 |
| Payment 8 | 209.39 | 1,150.65 | 1,360.04 |
| Payment 9 | 187.83 | 1,172.21 | 1,360.04 |
| Payment 10 | 165.84 | 1,194.20 | 1,360.04 |
| Payment 11 | 143.45 | 1,216.59 | 1,360.04 |
| Payment 12 | 120.64 | 1,239.40 | 1,360.04 |
| Payment 13 | 97.41 | 1,262.63 | 1,360.04 |
| Payment 14 | 73.73 | 1,286.31 | 1,360.04 |
| Payment 15 | 49.61 | 1,310.43 | 1,360.04 |
| Payment 16 | 25.08 | 1,334.96 | 1,360.04 |
| Total | $2,760.64 | $19,000.00 | $21,760.64 |

| 20 Payment Plan | 7½% Charge | Trust Deposit | Total Payment |
|---|---|---|---|
| Payment 1 | $ -0- | $ 1,126.89 | $ 1,126.89 |
| Payment 2 | 335.13 | 791.76 | 1,126.89 |
| Payment 3 | 320.28 | 806.61 | 1,126.89 |
| Payment 4 | 305.17 | 821.72 | 1,126.89 |
| Payment 5 | 289.75 | 837.14 | 1,126.89 |
| Payment 6 | 274.06 | 852.83 | 1,126.89 |
| Payment 7 | 258.07 | 868.82 | 1,126.89 |
| Payment 8 | 241.78 | 885.11 | 1,126.89 |
| Payment 9 | 225.18 | 901.71 | 1,126.89 |
| Payment 10 | 208.28 | 918.61 | 1,126.89 |
| Payment 11 | 191.05 | 935.84 | 1,126.89 |
| Payment 12 | 173.51 | 953.38 | 1,126.89 |
| Payment 13 | 155.63 | 971.26 | 1,126.89 |
| Payment 14 | 137.42 | 989.47 | 1,126.89 |
| Payment 15 | 118.88 | 1,008.01 | 1,126.89 |
| Payment 16 | 99.97 | 1,026.92 | 1,126.89 |
| Payment 17 | 80.72 | 1,046.17 | 1,126.89 |
| Payment 18 | 61.10 | 1,065.79 | 1,126.89 |
| Payment 19 | 41.11 | 1,085.78 | 1,126.89 |
| Payment 20 | 20.71 | 1,106.18 | 1,126.89 |
| Total | $3,537.80 | $19,000.00 | $22,537.80 |

Payment #1 due upon acceptance. All other payments are due on a quarterly basis.

**CLASS 7 — $22,000.00**

| 12 Payment Plan | 7½% Charge | Trust Deposit | Total Payment |
|---|---|---|---|
| Payment 1 | $ -0- | $ 2,026.33 | $ 2,026.33 |
| Payment 2 | 374.50 | 1,651.83 | 2,026.33 |
| Payment 3 | 343.53 | 1,682.80 | 2,026.33 |
| Payment 4 | 311.98 | 1,714.35 | 2,026.33 |
| Payment 5 | 279.83 | 1,746.50 | 2,026.33 |
| Payment 6 | 247.09 | 1,779.24 | 2,026.33 |
| Payment 7 | 213.73 | 1,812.60 | 2,026.33 |
| Payment 8 | 179.74 | 1,846.59 | 2,026.33 |
| Payment 9 | 145.13 | 1,881.20 | 2,026.33 |
| Payment 10 | 109.86 | 1,916.47 | 2,026.33 |
| Payment 11 | 73.92 | 1,952.41 | 2,026.33 |
| Payment 12 | 36.65 | 1,989.68 | 2,026.33 |
| Total | $2,315.96 | $22,000.00 | $24,315.96 |

| 16 Payment Plan | 7½% Charge | Trust Deposit | Total Payment |
|---|---|---|---|
| Payment 1 | $ -0- | $ 1,574.78 | $ 1,574.78 |
| Payment 2 | 382.97 | 1,191.81 | 1,574.78 |
| Payment 3 | 360.61 | 1,214.17 | 1,574.78 |
| Payment 4 | 337.85 | 1,236.93 | 1,574.78 |
| Payment 5 | 314.66 | 1,260.12 | 1,574.78 |
| Payment 6 | 291.04 | 1,283.74 | 1,574.78 |
| Payment 7 | 266.96 | 1,307.82 | 1,574.78 |
| Payment 8 | 242.45 | 1,332.33 | 1,574.78 |
| Payment 9 | 217.46 | 1,357.32 | 1,574.78 |
| Payment 10 | 192.01 | 1,382.77 | 1,574.78 |
| Payment 11 | 166.10 | 1,408.68 | 1,574.78 |
| Payment 12 | 139.68 | 1,435.10 | 1,574.78 |
| Payment 13 | 112.77 | 1,462.01 | 1,574.78 |
| Payment 14 | 85.36 | 1,489.42 | 1,574.78 |
| Payment 15 | 57.44 | 1,517.34 | 1,574.78 |
| Payment 16 | 29.12 | 1,545.66 | 1,574.78 |
| Total | $3,196.48 | $22,000.00 | $25,196.48 |

| 20 Payment Plan | 7½% Charge | Trust Deposit | Total Payment |
|---|---|---|---|
| Payment 1 | $ -0- | $ 1,304.83 | $ 1,304.83 |
| Payment 2 | 388.06 | 916.77 | 1,304.83 |
| Payment 3 | 370.87 | 933.96 | 1,304.83 |
| Payment 4 | 353.35 | 951.48 | 1,304.83 |
| Payment 5 | 335.52 | 969.31 | 1,304.83 |
| Payment 6 | 317.34 | 987.49 | 1,304.83 |
| Payment 7 | 298.82 | 1,006.01 | 1,304.83 |
| Payment 8 | 279.96 | 1,024.87 | 1,304.83 |
| Payment 9 | 260.75 | 1,044.08 | 1,304.83 |
| Payment 10 | 241.17 | 1,063.66 | 1,304.83 |
| Payment 11 | 221.23 | 1,083.60 | 1,304.83 |
| Payment 12 | 200.91 | 1,103.92 | 1,304.83 |
| Payment 13 | 180.21 | 1,124.62 | 1,304.83 |
| Payment 14 | 159.12 | 1,145.71 | 1,304.83 |
| Payment 15 | 137.65 | 1,167.18 | 1,304.83 |
| Payment 16 | 115.76 | 1,189.07 | 1,304.83 |
| Payment 17 | 93.47 | 1,211.36 | 1,304.83 |
| Payment 18 | 70.75 | 1,234.08 | 1,304.83 |
| Payment 19 | 47.61 | 1,257.22 | 1,304.83 |
| Payment 20 | 24.05 | 1,280.78 | 1,304.83 |
| Total | $4,096.60 | $22,000.00 | $26,096.60 |

Payment #1 due upon acceptance. All other payments are due on a quarterly basis.

**CLASS 8 — $25,000.00**

| 12 Payment Plan | 7½% Charge | Trust Deposit | Total Payment |
|---|---|---|---|
| Payment 1 | $ -0- | $ 2,302.65 | $ 2,302.65 |
| Payment 2 | 425.57 | 1,877.08 | 2,302.65 |
| Payment 3 | 390.37 | 1,912.28 | 2,302.65 |
| Payment 4 | 354.52 | 1,948.13 | 2,302.65 |
| Payment 5 | 317.99 | 1,984.66 | 2,302.65 |
| Payment 6 | 280.78 | 2,021.87 | 2,302.65 |
| Payment 7 | 242.88 | 2,059.77 | 2,302.65 |
| Payment 8 | 204.25 | 2,098.40 | 2,302.65 |
| Payment 9 | 164.91 | 2,137.74 | 2,302.65 |
| Payment 10 | 124.83 | 2,177.82 | 2,302.65 |
| Payment 11 | 84.00 | 2,218.65 | 2,302.65 |
| Payment 12 | 41.70 | 2,260.95 | 2,302.65 |
| Total | $2,631.80 | $25,000.00 | $27,631.80 |

| 16 Payment Plan | 7½% Charge | Trust Deposit | Total Payment |
|---|---|---|---|
| Payment 1 | $ -0- | $ 1,789.52 | $ 1,789.52 |
| Payment 2 | 435.19 | 1,354.33 | 1,789.52 |
| Payment 3 | 409.79 | 1,379.73 | 1,789.52 |
| Payment 4 | 383.93 | 1,405.59 | 1,789.52 |
| Payment 5 | 357.56 | 1,431.96 | 1,789.52 |
| Payment 6 | 330.72 | 1,458.80 | 1,789.52 |
| Payment 7 | 303.37 | 1,486.15 | 1,789.52 |
| Payment 8 | 275.51 | 1,514.01 | 1,789.52 |
| Payment 9 | 247.12 | 1,542.40 | 1,789.52 |
| Payment 10 | 218.20 | 1,571.32 | 1,789.52 |
| Payment 11 | 188.74 | 1,600.78 | 1,789.52 |
| Payment 12 | 158.73 | 1,630.79 | 1,789.52 |
| Payment 13 | 128.15 | 1,661.37 | 1,789.52 |
| Payment 14 | 97.00 | 1,692.52 | 1,789.52 |
| Payment 15 | 65.26 | 1,724.26 | 1,789.52 |
| Payment 16 | 33.05 | 1,756.47 | 1,789.52 |
| Total | $3,632.32 | $25,000.00 | $28.632.32 |

| 20 Payment Plan | 7½% Charge | Trust Deposit | Total Payment |
|---|---|---|---|
| Payment 1 | $ -0- | $ 1,482.76 | $ 1,482.76 |
| Payment 2 | 440.94 | 1,041.82 | 1,482.76 |
| Payment 3 | 421.41 | 1,061.35 | 1,482.76 |
| Payment 4 | 401.51 | 1,081.25 | 1,482.76 |
| Payment 5 | 381.24 | 1,101.52 | 1,482.76 |
| Payment 6 | 360.58 | 1,122.18 | 1,482.76 |
| Payment 7 | 339.54 | 1,143.22 | 1,482.76 |
| Payment 8 | 318.11 | 1,164.65 | 1,482.76 |
| Payment 9 | 296.26 | 1,186.50 | 1,482.76 |
| Payment 10 | 274.03 | 1,208.73 | 1,482.76 |
| Payment 11 | 251.37 | 1,231.39 | 1,482.76 |
| Payment 12 | 228.28 | 1,254.48 | 1,482.76 |
| Payment 13 | 204.76 | 1,278.00 | 1,482.76 |
| Payment 14 | 180.79 | 1,301.97 | 1,482.76 |
| Payment 15 | 156.38 | 1,326.38 | 1,482.76 |
| Payment 16 | 131.51 | 1,351.25 | 1,482.76 |
| Payment 17 | 106.18 | 1,376.58 | 1,482.76 |
| Payment 18 | 80.36 | 1,402.40 | 1,482.76 |
| Payment 19 | 54.07 | 1,428.69 | 1,482.76 |
| Payment 20 | 27.88 | 1,454.88 | 1,482.76 |
| Total | $4,655.20 | $25,000.00 | $29,655.20 |

Payment #1 due upon acceptance. All other payments are due on a quarterly basis.

**CLASS 9 — $28,000.00**

| 12 Payment Plan | 7½% Charge | Trust Deposit | Total Payment |
|---|---|---|---|
| Payment 1 | $ -0- | $ 2,578.96 | $ 2,578.96 |
| Payment 2 | 476.64 | 2,102.32 | 2,578.96 |
| Payment 3 | 437.22 | 2,141.74 | 2,578.96 |
| Payment 4 | 397.06 | 2,181.90 | 2,578.96 |
| Payment 5 | 356.15 | 2,222.81 | 2,578.96 |
| Payment 6 | 314.48 | 2,264.48 | 2,578.96 |
| Payment 7 | 272.02 | 2,306.94 | 2,578.96 |
| Payment 8 | 228.76 | 2,350.20 | 2,578.96 |
| Payment 9 | 184.69 | 2,394.27 | 2,578.96 |
| Payment 10 | 139.80 | 2,439.16 | 2,578.96 |
| Payment 11 | 94.07 | 2,484.89 | 2,578.96 |
| Payment 12 | 46.63 | 2,532.33 | 2,578.96 |
| Total | $2,947.52 | $28,000.00 | $30,947.52 |

| 16 Payment Plan | 7½% Charge | Trust Deposit | Total Payment |
|---|---|---|---|
| Payment 1 | $ -0- | $ 2,004.26 | $ 2,004.26 |
| Payment 2 | 487.42 | 1,516.84 | 2,004.26 |
| Payment 3 | 458.97 | 1,545.29 | 2,004.26 |
| Payment 4 | 430.00 | 1,574.26 | 2,004.26 |
| Payment 5 | 400.48 | 1,603 78 | 2,004.26 |
| Payment 6 | 370.41 | 1,633.85 | 2,004.26 |
| Payment 7 | 339.78 | 1,664.48 | 2,004.26 |
| Payment 8 | 308.57 | 1,695.69 | 2,004.26 |
| Payment 9 | 276.77 | 1,727.49 | 2,004.26 |
| Payment 10 | 244.38 | 1,759.88 | 2,004.26 |
| Payment 11 | 211.39 | 1,792.87 | 2,004.26 |
| Payment 12 | 177.77 | 1,826.49 | 2,004.26 |
| Payment 13 | 143.52 | 1,860.74 | 2,004.26 |
| Payment 14 | 108.63 | 1,895.63 | 2,004.26 |
| Payment 15 | 73.09 | 1,931.17 | 2,004.26 |
| Payment 16 | 36.98 | 1,967.28 | 2,004.26 |
| Total | $4,068.16 | $28,000.00 | $32,068.16 |

| 20 Payment Plan | 7½% Charge | Trust Deposit | Total Payment |
|---|---|---|---|
| Payment 1 | $ -0- | $ 1,660.69 | $ 1,660.69 |
| Payment 2 | 493.89 | 1,166.80 | 1,660.69 |
| Payment 3 | 472.01 | 1,188.68 | 1,660.69 |
| Payment 4 | 449.72 | 1,210.97 | 1,660.69 |
| Payment 5 | 427.01 | 1,233.68 | 1,660.69 |
| Payment 6 | 403.88 | 1,256.81 | 1,660.69 |
| Payment 7 | 380.32 | 1,280.37 | 1,660.69 |
| Payment 8 | 356.31 | 1,304.38 | 1,660.69 |
| Payment 9 | 331.85 | 1,328.84 | 1,660.69 |
| Payment 10 | 306.94 | 1,353.75 | 1,660.69 |
| Payment 11 | 281.55 | 1,379.14 | 1,660.69 |
| Payment 12 | 255.69 | 1,405.00 | 1,660.69 |
| Payment 13 | 229.35 | 1,431.34 | 1,660.69 |
| Payment 14 | 202.51 | 1,458.18 | 1,660.69 |
| Payment 15 | 175.17 | 1,485.52 | 1,660.69 |
| Payment 16 | 147.31 | 1,513.38 | 1,660.69 |
| Payment 17 | 118.94 | 1,541.75 | 1,660.69 |
| Payment 18 | 90.03 | 1,570.66 | 1,660.69 |
| Payment 19 | 60.58 | 1,600.11 | 1,660.69 |
| Payment 20 | 30.74 | 1,629.95 | 1,660.69 |
| Total | $5,213.80 | $28,000.00 | $33,213.80 |

## Title XI
## Comments on more than one section (also includes some Title XVIII):

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D. C. Alexander
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July 16, 1987

Robert J. Leonard, Esq.
Chief Counsel
Committee on Ways & Means
U.S. House of Representatives
Room 1102
Longworth House Office Building
Washington, D.C. 20515

Re: H.R. 2636 - Amendments to Title XI

Dear Mr. Leonard:

This letter is in response to the request of the Ways and Means Committee for comments on H.R. 2636, the Technical Corrections Act of 1987. As you know, Title XI of the 1986 Act extensively amended Code section 403(b) (relating to employee annuities purchased by certain exempt organizations) and Code section 457 (relating to deferred compensation plans of governments and exempt organizations). The staffs of the tax committees have done an impressive job of identifying and correcting technical problems contained in Title XI, including several that affect sections 403(b) and 457. Section 111(e)(2) of the technical corrections bill, which eliminates the otherwise conflicting distribution requirements of sections 401(a)(9)(A)(i) and 457(d)(1)(A), is of particular importance to the continued viability of deferred compensation plans for employees of State and local governments. We strongly endorse the solution adopted in section 111(e)(2).

Although H.R. 2636 resolves in a satisfactory manner most of the technical problems under Title XI, we believe that several additional corrections are needed in order to implement fully the intent of Congress in amending sections 403(b) and 457. In the remainder of this letter, we will describe these additional technical problems and propose legislative solutions.

1. Employee Annuities: Constructive Receipt. Prior to the 1986 Act, amounts could be distributed to an employee holding a section 403(b) annuity contract at any time. However, the ability of the employee to treat the annuity contract as a short-term investment account was limited by Revenue Rulings 77-85, 80-274, and 81-255, which held (1) that an annuity contract with a separate account invested in a mutual fund or other investment available to the general public would not be treated as a section 403(b) annuity and (2) that the holder of the contract would be treated as in constructive receipt of the earnings and gains on the investment. The effect of these revenue rulings was to prevent the use of section 403(b) annuities to defer taxes on income from investments that could be cashed out at any time.

Section 1123 of the Tax Reform Act of 1986 amended Code section 403(b) to prohibit distributions under a section 403(b) employee annuity before the employee's death, disability, attainment of age 59-1/2, or separation from service. Section 1122(d)(1) of the Act amended Code section 403(a)(1) to provide that employees would not be treated as in receipt of annuity amounts before they were actually distributed to the employee. In effect, there was a statutory trade-off, in which Congress limited the circumstances under which amounts could be distributed from an employee annuity, while providing that no amount would be treated as distributed prior to actual distribution.

Although section 1122(d)(1) succeeds in making clear that the holder of an employee annuity will not be taxed on the grounds of constructive receipt, the revenue rulings had treated constructive receipt as grounds, not only for taxing the employee, but also for disqualifying the contract as a section 403(b) annuity. Section 1122(d)(1) will fail in its purposes to protect employees from taxation on undistributed annuity amounts if the circumstances that would otherwise give rise to constructive receipt are treated as disqualifying the annuity. To effectuate the purpose of Congress in enacting section 1122(d)(1), a technical correction is necessary to clarify that the circumstances described in the revenue rulings on constructive receipt will not disqualify the annuity under section 403(b). Specifically, we propose that section 403(b) be amended by adding the following new paragraph:

> "(13) SEPARATE ACCOUNTS-A contract shall not fail to qualify as an annuity contract under this subsection solely because a life insurance company separate account in which the reserves for such contract are held invests in shares of one or more mutual funds or other investment interests that are sold directly or indirectly to the general public."

2. Statutory Deferred Compensation: Minimum Distribution Requirements. The House and Senate versions of the 1986 Act would have amended section 457 to specify a "required beginning date" at section 457(d)(2)(A) and a "pay-out requirement" at section 457(d)(2)(B). According to the August 16 Joint Committee explanation of the Conference Report, these minimum distribution requirements were modified in conference to substitute the "required beginning date" of section 401(a)(9) for the "required beginning date" of the House/Senate version. In fact, the modification approved by the Conference Committee picked up all of the requirements of section 401(a)(9), not just the "required beginning date". As a result, the pay-out requirements of section 401(a)(9) were added to section 457(d)(2)(A) even though the pay-out requirements of the House/Senate version had not been deleted from section 457(d)(2)(B). Although the pay-out rules under section 401(a)(9) and section 457(d)(2)(B) are generally comparable, the detailed requirements are very different. Neither rule requires a faster pay-out than the other rule. It depends entirely on the age and other characteristics of the employee and his beneficiaries.

Presumably, the purpose of the Conference Committee when it substituted the reference to section 401(a)(9) for the original "beginning date" requirement was to simplify the law by applying to section 457 plans the same rules that apply to other statutory plans of deferred compensation. That purpose would be frustrated if state and local governments and exempt organizations were required, every time a covered employee separated from service, to calculate a pay-out schedule under two different Code provisions in order to determine which provision required the faster pay-out. We therefore propose that the unnecessary and unintended duplication of pay-out requirements be eliminated by deleting the superfluous pay-out requirement now found at section 457(d)(2)(B). Specifically, we propose that section 457(d) be amended to read as follows:

"(d) DISTRIBUTION REQUIREMENTS. - For purposes of subsection (b)(5), a plan meets the distribution requirements of this subsection if --

(A) under the plan amounts will not be made available to participants or beneficiaries earlier than --

(i) the calendar year in which the participant attains 70-1/2,

(ii) when the participant is separated from service with the employer, or

(iii) when the participant is faced with an unforeseeable emergency (determined in the manner prescribed by the Secretary in Regulations), and

(B) the plan meets the requirements of section 401(a)(9)."

3. Statutory Deferred Compensation: Constructive Receipt. Section 457(e)(9) provides that an amount payable to a participant in a statutory deferred compensation plan is not treated as "made available" merely because the participant may elect to receive a lump sum payable within 60 days of the election, provided that the total amount payable to the participant does not exceed $3,500 and no additional amounts may be deferred under the plan with respect to the participant. It seems clear that section 457(e)(9) would prevent constructive receipt of amounts scheduled to be paid over a period of years after separation from service even though the participant could have elected a lump sum payment instead. What is less clear is whether section 457(e)(9) allows an eligible deferred compensation plan to pay a lump sum before separation from service where the amount does not exceed $3,500 and no additional amounts may be deferred under the plan. Section 457(d)(1) disqualifies a section 457 plan if amounts are "made available" before separation from service or unforeseeable emergency. However, section 457(e)(9) specifically provides that the lump-sum option described therein does not cause amounts to be treated as "made available".

After reviewing the pertinent Committee reports, we have found no indication that Congress intended to allow lump-sum distributions before separation from service. A lump-sum option exercised during service should not disqualify a plan if the lump-sum is not payable until after separation, because the option to choose does not accelerate the availability of the funds. However, if the funds are payable before separation from service (even within 60 days of election) this would appear to disqualify the plan.

Owing to the somewhat different functions of the phrase "made available" in sections 457(e)(9) and section 457(d)(1), there is a possibility that some sponsors of section 457 plans might feel free to allow in-service lump-sum distributions to employees who agree to terminate participation in the plan. To clarify such distributions are impermissible, we propose that section 457(e)(9) be amended by deleting the period at the end thereof and adding the following:

"and after separation from service."

We would be pleased to discuss the merits of our proposed technical corrections at your convenience. If you have any questions, please give me or my colleague Bill Chip a call.

With best wishes,

Sincerely,

Donald C. Alexander

Donald C. Alexander

AMERICAN SOCIETY OF PENSION ACTUARIES

**Howard Phillips, Chairman**
**Government Affairs Committee**
**60 Route 46 East**
**Fairfield, New Jersey 07007**
**(201) 575-1100**

July 24, 1987

The Honorable Dan Rostenkowski
Chairman, Ways and Means Committee
1102 LHOB
Washington, D. C. 20515-6348

Dear Congressman Rostenkowski:

The American Society of Pension Actuaries represents more than 2,000 actuaries and consultants who represent clients who sponsor a significant percentage of the private retirement plans in the United States. ASPA is pleased to provide you with comments you seek on H. R. 2636, the Technical Corrections Act of 1987. Our comments will include technical corrections which are needed to the Technical Corrections Bill, and will include our suggestions for items needing clarification or change in connection with the retirement provisions of the Tax Reform Act of 1986. These suggestions involve areas which we believe were overlooked in preparing the retirement plan portion of the Technical Corrections Act of 1987, and should be addressed if the pension community is to understand how to operate under the Tax Reform Act of 1986.

I have separated the lists into two parts. One member of ASPA is responsible for each part, and will be available to you if further discussion is needed on any one of the items in either of the parts. The contact for Part I is:

Mr. Edward E. Burrows
PENTAD
360 Bear Hill Road
Waltham, Massachusetts 02154

(617) 890-1780

The contact for Part II is:

Mrs. Marjorie Martin
Noble Lowndes Becker
33 Evergreen Place
East Orange, New Jersey 07018

(201) 675-8900

ASPA is pleased to have this opportunity to provide these comments and suggestions to you. If I can assist you in any other way in this regard, please contact me.

Sincerely,

Howard M. Phillips, F.S.A., M.S.P.A.
Chairman

## PROPOSED CHANGES IN TECHNICAL CORRECTIONS BILL

## PART I

SEC. 111(c)

- This first item refers to adjustments of refunded excess deferrals, excess contributions and excess aggregate contributions to reflect investment results. Apparently, the intent is to require adjustments which reflect the period between the end of the year of reference and the date of distribution.

  If this approach must be taken, it seems urgent that a rough justice method be mandated. One such method would be to determine investment results for the year of reference and then extrapolate these results to the date of distribution. It would have to be provided that the method will not serve to reduce the account balance below zero.

- Clarify that unless a contribution which matches a refunded excess contribution is removed, the result violates 401(a)(4).

SEC. 111(d)

- Delete the proposed provision precluding the actuary from anticipating inflationary changes in the $200,000 limitation.

- Provide that a contribution which is necessary under 412 but non-deductible because of 404(a)(8) is exempt from the non-deductible contribution excise tax of 4972.

- Incorporate a similar provision exempting a contribution which is required under 412 but not currently deductible because of 263A.

- This next item involves the process of measuring years of participation for purposes of 415(b)(5) and 415(e). There has been great consternation and uncertainty over this issue.

  Current thinking seems to be that participation in a DC prior to participation in a DB will not count either for 415(b) or for 415(e).

  Current thinking seems to be that participation in a DC following participation in a DB will count for 415(e). However, years of DC participation will be factored in year by year. In contrast, where the individual remains a participant in a non-terminated DB, it is permissible to project future participation.

  We are all coming to the realization that nobody had ever given adequate thought to the question of projecting service after service had terminated. However, it appears to have been conventional practice not to change the DB fraction merely because service had terminated. The analogue, now that participation is what counts, is that the fraction should not be changed merely because participation has terminated.

  The objective, in changing from service to participation, seems worth restating. It was to prevent entrepreneurs from waiting to install plans until they themselves were almost ready to retire. There was concern that plans were being established for just a brief window period until the entrepreneur retired. In light of this objective we suggest these changes:

  a) Count participation in a DC prior to participation in a DB for both 415(b) and 415(e).

  b) i) Clarify that, in general, the DB fraction is not affected by cessation of service or participation, or, if this is impossible,

     ii) Count participation in a DC following participation in a DB for 415(e) purposes and permit the same approach to projection that is permitted during DB participation.

c) Permit the sponsor to establish participation retroactively, provided the approach is taken consistently and former employees are included.

This last proposal is admittedly not new. We made it originally a year ago. Nevertheless, we are hopeful that with all the consternation which has accompanied the change from service to participation, there will be a receptiveness to proposals for modification.

SEC. 111(g)

- Revise 401(l) so that for offset plans the key factor is the Primary Insurance Amount calculated under reasonable rules incorporated in the plan, rather than "Final Average Compensation".
- Restore the former degree of permitted disparity for Social Security integration purposes, but restore the requirement that adjustments be made for ancillary benefits. Restoration of the former degree of permitted disparity would require increasing each .75 factor to about 1.07. The current format of 401(l) encourages plan design which incorporates rich ancillaries.

SEC. 111(h)

- This item deals with 401(a)(26). We believe this section has demonstrated itself to have more extensive impact than was originally contemplated. We continue to believe that 401(a)(26) is not good policy and should be repealed. Short of that, many problems could be avoided by supplemental legislative history. This would reverse the legislative history which is there now, and establish that a single plan involving multiple benefit formulas may be treated as a single plan.

  The definition of a single plan would involve the concept that there is no partitioning of fund assets. That is, all assets would be available to meet liabilities respecting all groups of participants under the plan.

SEC. 111(j)

- Establish a single definition of family member status. The new one proposed for utilization with the $200,000 limitation of 401(a)(17) and 404(l), would seem totally satisfactory as the only one for all purposes.

SEC. 111(m)

- Clarify that a plan is not required to specify how qualified matching and qualified non-elective contributions will be assigned between (k)(3) and (m)(2) tests. That is, the plan sponsor may dictate assignment from year to year.

  The resultant discretion is merely analogous to the discretion involved in assigning deductible contributions under 404(a)(7).

SEC. 111(B)

- Delete the proposed 89 change respecting the rule permitting application of the 50/90 test separately to dependent coverage, ignoring employees without dependents.

  Under the proposed change, separate testing would be precluded, but employees without dependents could be treated as if they had dependents and dependent coverage. This change would require imposition of a discretionary test. While the illustration at Page 145 of the Joint Committee description seems clear, there will be many borderline cases. The thrust has been in the direction of bright line tests. There seems to be no reason why this thrust should be abandoned, here.

  We are not impressed by the proposition that the change would relieve employers of much of a burden. An employer these days who does not keep records on employee family status is courting trouble. However, if some folks disagree with us, it might make sense if utilization of the proposed change were available on an optional basis.

- Under 89, change the definition of employer financed benefit associated with definitions of comparable plans for purposes of the 80% test. Provide that salary reduction contributions are treated as employee contributions. This change would accommodate employers who have been satisfying the HMO Act by establishing a fixed employer contribution and varying employee contributions. At present, these employers will probably be able to satisfy the 80% test if employee contributions are accepted on an after-tax basis. But they may have trouble if they have utilized 125 to accept employee contributions on a before-tax basis.

- Provide a mandate that benefit valuation rules under 89 be consistent with rules for determining compliance with the HMO Act. We are concerned that 89 benefit valuation procedures may be adopted which ignore the question of whether coverage is through an HMO. This could lead to a situation where compliance with the HMO Act will make it difficult to satisfy 89.

## PROPOSED CHANGES IN TECHNICAL CORRECTIONS BILL

## PART II

SEC. 111(d)

Code Section 415(e): If these overly complex rules are to be retained, additional transitional rules should be provided. The calculation of the defined contribution fraction involves a great deal of historical data which in many cases has not been retained because it was clear, based on the prior limitations, that the restrictions would not apply. As a result of the significantly reduced defined benefit limit, many more individuals are potentially affected by the dual plan limits. This will undoubtedly generate significant administrative and auditing costs.

COLA on $200,000 Compensation Limit: The explanation to the proposed Technical Corrections Act indicates that this COLA starts in 1990 for post-1988 increases. However, Code Section 401(a)(17) indicates that this COLA is to be adjusted at the same time and in the same manner as under Section 415(d) which in turn provides for post-1987 increases.

SEC. 111(g)

Social Security Retirement Age: The definition of the Social Security Retirement Age to be used for Code Section 415 is fashioned by reference to the Social Security Act "without regard to the age increase factors". This translates to truncating the Social Security Retirement Ages to the next lowest full year. This is contrary to the ages specified in the Senate Finance Committee explanation which apparently were intended according to Congressional staffers.

SEC. 111(h)

Minimum Participation Rule: Code Section 401(a)(26) provides that the new minimum participation rule must be satisfied on each day of the Plan Year. This is difficult to test from the plan administrator's point of view as well as difficult for the IRS to audit. Satisfaction of the rule on the first and/or last day of the Plan Year should be sufficient.

Minimum Participation Rule - Terminations and Mergers: Guidance is requested regarding the applicability of the "eligible amount" in the context of a plan merger in response to the minimum participation rule where two or more defined benefit plans are merged. Funds are not earmarked or distributed to plan participants in any way, nor are excess assets refunded to the employer. Unless a plan termination is undertaken in conjunction with a merger, it would seem that the reversion penalty and "eligible amount" restrictions are not relevant. As a result there is no need to reference mergers in the statute.

With respect to the actual determination of the present value, the rule should be clarified due to the change in the rate under Code Sections 401(a)(11) and 417. Plans which used the PBGC immediate annuity interest rate in accordance with IRS regulations and subsequently changed to the PBGC deferred annuity interest rate to conform to the 1986 Tax Reform Act should not be viewed as having changed their rate after August 16, 1986.

SEC. 111(j)

$200,000 Compensation Limitation: The proposed Technical Corrections Act clarifies the application of the $200,000 compensation limitation for purposes of the family member aggregation rules with respect to Plan Years beginning after December 31, 1988. A similar clarification is needed for applying the $200,000 cap for purposes of the 401(k) and 401(m) testing of top-heavy plans for 1987 and 1988 Plan Years.

$200,000 Compensation Limitation - Integration Rule: Guidance should be provided regarding the allocation of compensation in excess of the family group's aggregated integration level. The proposed Technical Corrections Act explains how the family members are added together, but does not explain how the resulting contribution/benefit (individually limited to $30,000/$90,000) is apportioned to the individuals.

SEC. 111(l)

Withdrawals from 401(k) Principal: Given that hardship withdrawals are limited to 401(k) contributions and not the investment experience attributable such contributions, computer systems must be modified to accumulate such amounts. It would be helpful if the account balance prior to the effective date of the new rule were grandfathered so that administrators need not reconstruct the information with respect to prior Plan Years.

SEC. 111(m)

Determination of Highly Compensated Employees: Unlike the determination of key employees under the top-heavy rules where individuals are identified as of the last day of the preceding Plan Year, the Highly Compensated Employee determination cannot be finalized until the end of the Plan Year for which the discrimination and coverage test are to be applied due to new hires, terminees, pay raises and bonuses. This is a significant stumbling block to attempts to monitor the 401(k) and 401(m) tests so as to avoid the need to make refunds and pay the 10% penalty. Adoption of the top-heavy approach, using the two Plan Years preceding the Plan Year to be tested, would alleviate this problem for administrators.

7,000 Deferral Limit: Although plans are not required to make refunds as requested by employees, some practitioners believe there may be a fiduciary duty to do so. However, other rules may make it impossible to provide the refund even if the employer is willing to do so. For example, since the refund is deemed to come from the first contributions of the calendar year (typically), a refund to a non-highly compensated employee could reduce the average deferral percentage for highly compensated employees with respect to a Plan Year which has already ended. A refund to a highly compensated employee will apparently require the forfeiture of the match which has already been allocated and communicated with respect to a prior Plan Year. These problems would be alleviated if the plan is permitted to treat the distribution as an in-service withdrawal and is not required to adjust prior valuations in any way.

SEC. 111(A)(b)

Partial Rollover Rule: In redrafting this rule under Code Section 402(a)(5) to reference the "lump sum distribution" under 402(e), language dealing with the balance at the time of the distribution was dropped. Was this intended? Frequently we see benefits distributed in two payments which often straddle two calendar years. A terminee is permitted to draw down his fixed income account, for example, but must wait until after the end of the valuation period to be paid his equity account. It would seem to further portability objectives to permit the rollover of both payments, but this is not clear from the statute.

SEC. 111(A)(f)

Tax on Excess Distributions: A clarification would be appreciated regarding the imposition of the Section 4981A tax on investment experience attributable to a participant's August 1, 1986, accrued benefit or account balance. If an individual has no additional benefit accrual or contribution after August 1, 1986, is the distribution of the entire benefit or account balance at a later date exempt or are the investment earnings subject to the tax?

SEC. 118(q)

Retirement Equity Act Technical Corrections: The five year repayment period was a welcomed clarification. However, the IRS apparently interprets Code Section 411 as requiring a cash-out or a five year break-in-service prior to the forfeiture of a terminated employee's forfeitable benefit. In most cases terminees are not rehired by the same employer. As a result the only way to access a forfeitable benefit is to cash-out the nonforfeitable benefit. This runs contrary to the objective of retaining the benefits for retirement purposes. Employers should be permitted to retain the nonforfeitable benefit in the plan while using the forfeitable portion for reallocation or the reduction of the required employer contribution as long as arrangements are made for restoring the forfeiture in the unlikely event the individual returns. Note that the immediate use of such forfeitures will have a favorable impact on the budget to the extent used to reduce current employer contributions.

# COMMENTS ON TECHNICAL CORRECTIONS LEGISLATION

SUBMITTED BY

THE ASSOCIATION OF PRIVATE PENSION AND WELFARE PLANS

JULY 24, 1987

Sec. 111(m)(11). This provision would amend section 4979(f)(2) to provide that excess contributions and excess aggregate contributions distributed within two and a half months after the end of the plan year are taxed in the year the contributions were made, unless these amounts do not exceed $100, in which case they are to be taxed in the year of distribution. This amendment would create an additional burden on plan administrators, on participants who would be required to file amended returns and on the IRS, which would be required to process those returns. We do not believe that the alleged abuse -- deferral of income -- would be significant enough to add this complexity to the law. If such an abuse is nonetheless deemed substantial, we would suggest that all distributions of excess contributions and excess aggregate contributions be taxed in the year of distribution at the rate which would have been applicable in the year of contribution.

Sec. 111(h)(2). This provision makes it clear that plans are deemed to meet the nondiscrimination rules in section 410(b) of the Code if they have no nonhighly compensated employees. We believe a similar rule -- deeming plans in compliance with the section 401(k) nondiscrimination rules -- should apply to plans with no nonhighly compensated employees under section 401(k). However, staff of the IRS and the Treasury have suggested that plans which cover no nonhighly compensated employees will be unable to maintain a qualified cash or deferred arrangement under section 401(k). We believe that this result is not justified, especially in view of the $7000 dollar limitation on elective deferrals. We would request express statutory authorization that such arrangement automatically satisfy section 401(k)(3).

Sec. 111A(g). This provision would allow a spouse who is the beneficiary of all retirement distributions of a decedent to elect not to have the 15% excess distribution excise tax under sec. 4981(A) of the Code apply but instead, aggregate that distribution with the spouse's own retirement benefits and have the tax apply to the spouse. We believe this is an excellent rule but would propose that the bill permit the election of the spouse if he or she is either the direct beneficiary or the income beneficiary of a trust into which the decedent's distribution is made.

Sec. 111(c), (g), (h), and (n) and 111A(e). All of these provisions deal with the effective dates for collectively bargained plans. The bill makes it clear that the delayed effective dates apply to the entire plan and not only those employees who are collectively bargained in the plan. We believe the same rule should apply for COBRA purposes under the continuation coverage provision in section 162(k). The proposed Treasury regulations implementing COBRA would apply different effective dates to different benefit schedules in the same plan. The same rule which applies to the nondiscrimination rules in sec. 1112 of TRA '86 should apply to COBRA.

Sec. 111(d). The Joint Committtee's explanation provides that the section 401(a)(17) $200,000 cap on compensation taken into account is not indexed until 1990. This indexing was to begin in 1988 and it is unclear how the 1990 date was arrived at. We object to this delay, which will further create disparities in benefit plan arrangements outside the qualified plan area for employees.

Sec. 111(h)(9). This provision would statutorily validate the Treasury's interpretation of section 401(a)(26) of the Code relating to waiver of the excise tax on reversions in the event of plan termination of a plan which would fail the minimum participation rules. The restrictions on the interest rate that may be used to determine the accrued benefits result in a cutback of accrued benefits, which is inconsistent with the protections that accrued benefits received with respect to the section 415 changes in TRA '86. We believe that this provision, and the Treasury's interpretation, go too far.

Sec. 111B(a)(25). This provision would make the controlled group rules of Code section 414(t) applicable to COBRA retroactively. In light of the enormous sanction in COBRA -- the loss of an employer's entire deduction regardless of how small or technical the violation -- it is unacceptable and grossly unfair to apply the rules retroactively. We would strike paragraph (a)(25), the effective date provision from this section of the bill, learning the date of enactment of technical corrections as the effective date.

Sec. 111B(i). This provision would require that in order to be excepted from the 84-month rule in section 409 of the Code, a distribution from a paysop or trasop must be (1) a lump sum distribution, within the meaning of another technical corrections change to the distribution rules for section 401(k) plans and (2) there may be no successor plan established. Thus, the distribution must constitute the balance to the credit of the employee from all similar plans, thereby encouraging distributions from plans which might otherwise be retained for retirement purposes. In addition, it would appear to prohibit use of the exception to the 84-month rule if the funds are transferred in a plan to plan transfer or, as has been suggested, would prohibit a distribution if the employer maintains another defined contribution plan. We think these restrictions are inconsistent with the repeal of the tax credit for ESOPs and the purpose of the TRA '86 provision to allow an exception to the 84-month rule. It will make that exception virtually useless, and when used, will encourage the dissolution of pension plan funds, rather than their protection for retirement.

Sec. 111B would also make changes in the diversification requirements. We would suggest an additional change. We believe the effective date for the diversification requirements should be with respect to contributions made with respect to a plan year beginning after 12/31/86, rather than a contribution made after that date. Since many PAYSOPs will be "frozen", it is an unnecessary burden to require diversification only with respect to that small amount of stock contributed in 1987 for the 1986 plan year.

Sec. 111(c). This provision would add new paragraph 401(a)(29), requiring as a condition of qualification that plans provide that no elective deferral in excess of the limits in section 402(g) will be permitted in all plans maintained by the employer. We believe that when applied on a controlled group basis, this rule is unnecessarily harsh and susceptible to innocent mistakes which would result in an inappropriately harsh sanction. In addition, this provision would require a plan amendment prior to the date all other plan amendments stemming from TRA '86 will be required -- "plan years after 12/31/87" instead of the more appropriate "plan years after 12/31/88".

Sec. 111(j). This provision would require a plan to exclude participants from the definition of highly compensated employee under Code section 414(g) if he or she is a nonresident alien who receives no earned U.S. source income from the employer. We believe that since this rule is intended to be a rule of convenience for employers, it ought not to be mandatory but a permissive exclusion at the discretion of the employer.

## Other Areas for Technical Corrections

TRA sec. 1131. The bill should exempt from the excise tax on nondeductible contributions those amounts which are contributed under ERISA Title IV to make a terminating defined benefit plan sufficient for benefits or to pay all of its withdrawal liability for a multiemployer plan. We believe these amounts should be deductible; however, failing that, they certainly should not draw an excise tax which would discourage responsible funding of benefits on termination of or withdrawal from plans.

## COBRA

The Code Sanction. We believe the sanction imposed by COBRA is excessive and thus unenforceable. If Treasury regulations are to be believed, it is imposed for the smallest technical violation, even if promptly corrected, even if inadvertent, even if the employee is at fault. We believe that this sanction should be modified, and only applied when the violation is not corrected by the due date for the employer's tax return after the close of the plan year in which the violation occurred.

Due Date of Premiums. Sec. 162(k) provides that a qualified beneficiary must be permitted to pay premiums 30 days after the date due. The rule allows a substantially more permissive rule for qualified beneficiaries than for active employees who generally must pay their share of a premium before the coverage period begins, e.g., on the first of the month for that month of coverage. The current rule allows a qualified beneficiary to receive a month of coverage without paying the premium, and leaves the plan sponsor with a collection burden which we believe is excessive. We would recommend that a plan be permitted to impose a due date for premiums, that when coupled with a grace period, still precede the coverage period.

## REA

Preretirement Survivor Annuity. Under Code section 417, a participant may not receive a preretirement survivor annuity, even with the consent of his or her spouse, until the participant reaches age 35 (or separates from service, if earlier). While sec. 118(q) of the bill clarifies the separation from service issue, we believe that this benefit should be waivable at any age.

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July 16, 1987

Robert J. Leonard, Esq.
Chief Counsel
Committee on Ways and Means
U. S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Re: Technical Corrections Bill of 1987 (H. R. 2636)

Dear Mr. Leonard:

Enclosed are comments pertaining to treatment under H. R. 2636 of the following issues:

1. Distributions upon termination of tax credit ESOPs;

2. Limitations on qualified plan benefits under Code Section 415;

3. Status of nonqualified plans supplementing qualified cash or deferred arrangements under Code Section 401(k); and

4. Deferred compensation plans under Code Section 457.

If further discussion with regard to these comments is desired, please contact Patrick J. Foley ((415) 442-1118) or Barry W. Homer ((415) 442-1151).

Very truly yours,

Barry W. Homer

Patrick J. Foley

Cynthia G. McCabe

Julie D. Gallagher

## TERMINATION OF TAX CREDIT ESOPs

### Description of Provision

Section 409(d) of the Code generally requires tax credit ESOPs to prohibit distributions of employer securities within 84 months following their allocation to a participant's account, except in certain enumerated situations. Section 1174(a)(1) of the Tax Reform Act of 1986 amended paragraph (1) of Section 409(d) by adding "termination of the plan" as an event making the prohibition requirement inapplicable. Section 111B(i)(1) of the Technical Corrections Bill of 1987 would strike out "termination of the plan" in Code Section 409(d)(1) and insert in its place "lump-sum distribution (within the meaning of Section 401(k)(10)(B)(ii)) upon the termination of the plan without the establishment of a successor plan".

Another provision of the Tax Reform Act of 1986 (Section 1171(a)) repealed the ESOP tax credit.

### Problem

As the House Ways and Means Committee report (p. 796) indicates, the Tax Reform Act amendment to Section 409(d)(1) was related to the expiration of the ESOP credit; Congress apparently intended to permit employers to terminate tax credit ESOPs "orphaned" by repeal of the credit and distribute their assets without regard to the 84-month rule. To give effect to this intent, however, the implications of other legal restrictions should be taken into account. In particular:

1. Consent Requirement: In most cases a defined contribution plan (such as a tax credit ESOP) that does not distribute benefits in the form of an annuity contract cannot be terminated without the consent of its participants. Under Code Section 411(a)(11), a benefit may not be immediately distributed to a participant having a vested benefit of over $3,500 without his or her consent. Thus, even a single participant who fails to consent may prevent a plan from terminating.

2. Section 16(b): The short-swing profits rule of Section 16(b) of the Securities Exchange Act of 1934 constitutes a strong disincentive to an officer of the employer to consent to a distribution of employer securities from a qualified plan such as a tax credit ESOP prior to the termination of his or her employment, since the distribution will generally be regarded for Section 16(b) purposes as a purchase of the distributed securities by the officer. This deemed purchase may be matched with any sale of employer securities within six months before or after the distribution date to result in liability to the officer. For this reason a tax credit ESOP which includes officers subject to Section 16(b) is unlikely to obtain their consent to an immediate distribution and distribute under Section 409(d)(1) as amended by the Tax Reform Act.

In combination, the two factors just cited prevent many public companies from terminating their tax credit ESOPs and taking advantage of the relief Congress intended to provide in amending Section 409(d)(1).

Solution

The relief Congress intended for employers can be reconciled with participants' interests by permitting accounts in the tax credit ESOP to be either distributed or transferred to another qualified defined contribution plan. To avoid the possibility of abusive arrangements that in effect, constitute termination/reestablishments, transferee plans should be restricted to plans other than ESOPs. Accordingly, Section 111B(i)(1) should be revised to read as follows:

> (1) Section 409(d) of the 1986 Code (relating to securities must stay in the plan) is amended--
>
> (A) by striking out "termination of the plan" in paragraph (1) thereof and inserting in lieu thereof "lump-sum distribution (within the meaning of Section 401(k)(10)(B)(ii)) after the termination of a plan, without establishment of a successor plan", and
>
> (B) by adding at the end thereof the following new sentence: "For purposes of this subsection, a plan is deemed terminated if all participants' accounts are distributed or transferred to a plan other than a plan defined in subsection (a) or section 4975(e)(7)."

## CHANGES TO SECTION 415

### Description of Provision

Section 1106 of the Tax Reform Act of 1986 ("Act") made several amendments to the Code with respect to the dollar limit on the annual benefits that may be provided by a qualified defined benefit pension plan under Section 415(b)(1)(A) ($90,000 for 1987).

Section 415(b)(5)(A), as amended by the Act, provides that in the case of an employee who has less that 10 years of participation in a defined benefit plan, the limitation of Section 415(b)(1)(A) is prorated over 10 years of participation. Prior law applied the phase-in based on a participant's years of service.

The Act also modifies Section 415(b)(2)(C) with respect to the reduction of the $90,000 limit for benefits commencing prior to social security retirement age. Under prior law, the limit was not reduced for benefits commencing on or after attainment of age 62.

Section 1106(i) of the Act provides that the amendments to Section 415 become effective for plan years beginning after December 31, 1986. A transitional rule protects accrued benefits under prior law under the terms of plan in force as of May 6, 1986.

### The Problems

The Technical Corrections Bill ("Bill") should address two areas in which the Act is ambiguous: First, the Bill should clarify that the 10 year phase-in of the $90,000 limit does not apply in determining the combined limitation under Section 415(e). Second, the Bill should clarify the application of the Act amendments to Section 415 to plans that terminated prior to the effective date of the Act.

1. Application of 10 Year Phase-in for 415(e).

In computing the combined limitations applicable when an employer maintains both a defined benefit plan and a defined contribution plan, Section 415(e)(2)(B) provides that the numerator of the defined benefit fraction is equal to the participant's projected annual benefit under the plan and the denominator is equal to the lesser of

> "(i) the product of 1.25 multiplied by the dollar limitation in effect under Section 415(b)(1)(A) for such year, or
>
> (ii) the product of-
> (I)1.4, multiplied by,
> (II) the amount which may be taken into account under subsection (b)(1)(B) with respect to such individual under the plan for such year."

Section 415(e)(2)(B) was not amended by the Act.

Under prior law, in applying the Section 415(b)(5)(A) adjustment to the Section 415(b)(1)(A) dollar limit for purposes of computing the denominator of the defined benefit fraction under Section 415(e)(2)(B)(i), a participant's years of service could be projected until normal retirement date.

Nothing in the Committee Reports to the Act clearly indicates whether it was Congress' intent that the Section 415(b)(1)(A) dollar limitation in effect for purposes of Section 415(e)(2)(B)(i) be adjusted under Section

415(b)(5)(A) based on years of participation rather than years of service as under prior law. In IRS Notice 87-21 (Q&A 7), the Service takes the position that the phase-in based on years of participation is to apply for purposes of computing the defined benefit fraction under Section 415(e). As under prior law with respect to the phase-in based on years of service, IRS Notice 87-21 provides that years of participation under Section 415(b)(5)(A) may be projected until normal retirement age for purposes of computing the Section 415(e) defined benefit fraction. However, in order to receive credit for a year of participation, Q&A 7 provides that a participant must meet the eligibility provisions and must be credited with a sufficient period of service under the plan in order to receive a benefit accrual for the year. Consequently, in the situation in which a plan is terminated, no further years of participation may be earned.

The Service's position raises an important issue as to whether Congress' purpose in adopting the amendments to Section 415(b)(5)(A), changing the 10 year phase-in from years of service to years of participation is furthered by applying it in calculating the combined limitations under Section 415(e).

Section 415(e) of the Code is intended to be a maximum career limit on the amount of contributions and benefits of an individual under an employer's qualified plans. Over the course of an individual's career, an employer's overall plan structure may change; new plans may be established and others terminated. If the Section 415(b)(5)(A) phase-in is applied based on years of participation to reduce the $90,000 limit in calculating the Section 415(e) combined limits, a participant in a defined benefit plan that is terminated prior to the time he or she earns 10 years of participation will have the denominator of the defined benefit fraction computed on the basis of the phased-in $90,000 limit. This will result in an increase the defined benefit fraction and a decrease the defined contribution fraction.

Since the participant's maximum career limit is based on a combined defined benefit fraction and defined contribution fraction which cannot exceed 1.0, the participant's ultimate retirement benefits may be substantially smaller than they would have been under prior law. This will have the greatest impact on the individuals with the shortest participation, who are more likely to be individuals early in their career. It could also have a substantial adverse effect on any participant with less that 10 years of participation in a defined benefit plan that will fail to meet the minimum participation test of Section 401(a)(26) of the Code and that will be required to be terminated before the 1989 plan year. For example, an individual who terminates a super top-heavy defined benefit plan with a $9,000 annual benefit after only one year of participation will have used his maximum career limit under Section 415(e) and will never thereafter be permitted to make any contribution to a defined contribution plan.

The General Explanation of the Tax Reform Act of 1986 prepared by the Joint Committee on Taxation ("Blue Book") provides that Congress anticipated that the Internal Revenue Service will provide rules permitting tacking of years of participation under separate plans in circumstances not inconsistent with the purposes of the phase-in. Blue Book, p. 739. Presumably, under this approach, the participant's combined limit, and hence his benefit accruals, could gradually increase during the phase-in period as the participant "earns" additional years of participation. However, even this approach would provide only limited relief, since substantial benefit accruals would be lost during the phase-in period.

Congress amended Section 415(b)(5)(A) to correct a perceived abuse: to provide a disproportionate benefit to a highly compensated employee, an employer would establish a defined benefit plan late in the employee's career and, by crediting past service, permit the accrual of a large benefit very rapidly. This amendment accomplishes the desired aim, but extending the restricted phase-in to calculation of the defined benefit fraction under Section 415(e) only results in curtailment of retirement benefits of a wide variety of employees--a clearly unintended consequence that should be corrected in the legislation.

2. Application of Section 415 Changes to Plans the Terminated Prior to the Effective Date of the Act.

Generally, where an employer which has terminated a defined benefit plan and maintains an ongoing defined contribution plan, reductions to comply with 415(e) combined limits cannot be made under the terminated plan; As a result, a participant's defined benefit fraction is a constant which limits the annual additions to the defined contribution plan on his behalf. In this situation, applying the Act's phase-in retroactively to the terminated defined benefit plan would penalize many participants in the defined contribution plan in a manner which serves no purpose or policy and which was not intended by Congress. The Act does not indicate that the amendments relating to the Section 415 dollar limit apply to plans that terminated prior to May 6, 1986--the date as of which benefits are generally "grandfathered"--but IRS Notice 87-21 (Q&A 19) adopts such a retroactive approach. Retroactive application to terminated plans places an unreasonable burden on employers by requiring them to recalculate the Section 415(e) combined benefit limit of any current plan participant who participated in the employer's terminated defined benefit plan, even if that plan was terminated many years ago. For many employers, this data may no longer be available or, at best, may be obtained only with extreme administrative effort and expense.

Solution

The Technical Corrections Bill should amend Section 415(e)(2)(B)(i) to clarify that the Section 415(b)(5)(A) phase-in of the Section 415(b)(1)(A) dollar limitation is determined based on years of service, as under prior law, rather than on years of participation. Absent this, at a minimum, Section 415(e)(2)(B)(i) should be amended to permit tacking of years of participation under separate plans maintained after the termination of a defined benefit plan. In addition, the effective date provisions of Section 1106(i) of the Act should be amended to clarify that the grandfather provisions of Section 1106 protect participants from recalculations of defined benefit fractions under plans terminated prior to May 6, 1986.

## NON-QUALIFIED CODA SUPPLEMENTAL PLANS

### Description of Provision

Section 1116(b)(3) of the Tax Reform Act of 1986, to become effective for years beginning after December 31, 1988, adds new Section 401(k)(4)(A) to the Code to read as follows:

> (A) BENEFITS (OTHER THAN MATCHING CONTRIBUTIONS) MUST NOT BE CONTINGENT ON ELECTION TO DEFER.--A cash or deferred arrangement of any employer shall not be treated as a qualified cash or deferred arrangement if any other benefit provided by such employer is conditioned (directly or indirectly) on the employee electing to have the employer make or not make contributions under the arrangement in lieu of receiving cash. The preceding sentence shall not apply to any matching contribution (as defined in Section 401(m) made by reason of such an election.

Section 111(l)(6) of the Technical Corrections Bill of 1987 would amend the first sentence of Section 401(k)(4)(A) by striking out "provided by such employer" to read as follows:

> A cash or deferred arrangement of any employer shall not be treated as qualified cash or deferred arrangement if any other benefit is conditioned (directly or indirectly) on the employee electing to have the employer make or not make contributions under the arrangement in lieu of receiving cash.

### Problem

This provision casts doubt on an employer's ability to maintain a nonqualified plan permitting employees to elect deferral of compensation which cannot be deferred under the employer's qualified cash or deferred arrangement ("CODA") because of legal restrictions relating to the qualified arrangement, such as the $7,000 limit on deferrals under qualified arrangements imposed by Code Section 402(g). It does not appear to have been Congressional intent to extend Section 401(k)(4)(A) so far.

The purpose of Section 401(k)(4)(A) is to protect the effectiveness of the nondiscrimination requirements of Section 401(k)(3) in limiting the benefits accorded to highly compensated employees under a CODA by preventing manipulative use of other benefits. Significantly, Section 401(k)(4)(A) permits matching contributions, which are subject to a separate nondiscrimination test. This rationale is evident in legislative history. In the House Ways and Means Committee report (pp. 692-93) and Senate Finance Committee Report (pp. 557-58), an example in which participation in a defined benefit plan is conditioned upon making contributions under a CODA is cited as a situation in which Section 401(k)(4)(A) would operate to disqualify the arrangement. The Statement of Managers (p. II-390) adds the example of voluntary after-tax employee contributions conditioned upon elective deferrals.

The provision of a supplementary nonqualified deferred compensation arrangement for employees who have reached legal limits to their deferrals under a CODA does not involve manipulation of the nondiscrimination tests. In fact, it should not be regarded as a "benefit" at all for tax law purposes, since the nonqualified arrangement--unlike the benefits cited as examples in legislative history--does not involve a tax subsidy. However, uncertainty as to the scope of "benefit" as used in Section 401(k)(4)(A) may discourage employers from maintaining supplemental plans by placing the qualification of their CODAs at risk.

## Solution

Clarify that the prohibition of benefits contingent on deferrals does not apply to nonqualified supplemental deferred compensation arrangements by amending Section 111(l)(6) of the Technical Corrections Bill to read as follows:

> (6) Section 401(k)(4)(A) of the 1986 Code (relating to other benefits must not be contingent on deferral election) is amended to read as follows:
>
> (A) BENEFITS (OTHER THAN MATCHING CONTRIBUTIONS) MUST NOT BE CONTINGENT ON ELECTION TO DEFER.--A cash or deferred arrangement of an employer shall not be treated as a qualified cash or deferred arrangement if any other benefit is conditioned (directly or indirectly) on the employee electing to have the employer make or not make contributions under the arrangement in lieu of receiving cash. The preceding sentence shall not apply to any matching contribution (as defined in Section 401(m)) made by reason of such an election or to the deferral, under a nonqualified plan, of compensation which cannot be deferred under the arrangement due to limits imposed by this part.

## SECTION 457 PLANS

### Description of Provision

Section 1107 of the Act amended Section 457 of the Code to apply the limitations and restrictions applicable to unfunded deferred compensation plans of state and local governments to such plans maintained by tax-exempt organizations. Amounts deferred may not exceed the lesser of (i) $7,500 or (ii) 33 1/3 percent of compensation, and the limit is reduced for amounts contributed to a simplified employee pension, a 401(k) plan, or other elective contribution arrangement. The Technical Corrections Bill of 1987 does not address the coverage of Section 457.

### Problem

The broad language of Section 457 as amended by the Act can be interpreted as covering all plans sponsored by a tax-exempt organization, whether or not tax-qualified and whether or not benefits are paid from employer assets rather than by means of deferral of compensation elected by the employee. If the contribution limits are interpreted to apply to non-qualified plans that do not involve actual deferral of compensation, tax-exempt organizations will be disadvantaged vis-a-vis taxpaying organizations, with no policy basis. For example, taxpaying organizations are not subject to limitations on "excess benefit" plans, which provide benefits in excess of allowable benefits under qualified plans, or "top hat" plans, which provide benefits only to a select group of executives or other highly compensated employees.

The Blue Book states that the purpose for the limits on unfunded deferred compensation for employees of governmental units and tax-exempt organizations is that the tension between an employee's desire to defer tax on compensation and the employer's desire to obtain a current deduction for compensation paid is not present, so that without limitations an excessive amount of deferred compensation may be accumulated. The same tension does not exist in the case of a nonqualified plan funded solely from employer assets, because the employee does not defer receipt of compensation otherwise owing (and thereby avoid current taxation) in order to participate in the plan.

The statute on its face appears to include only "true" deferred compensation plans. Section 457(b), in the definition of "eligible deferred compensation plan," specifies plans which provide "that compensation will be deferred for any calendar month only if an agreement providing for such deferral has been entered into before the beginning of such month..." Section 457(b)(4). Such an arrangement is characteristic of "true" deferred compensation plans, and is not applicable to plans providing benefits funded from employer assets unrelated to employees' elections.

### Proposed Solution

A technical correction should be made to Section 457 to clarify that the limitations do not apply to nonqualified plans under which nonelective benefits are paid from employer assets rather than by means of elective deferral of compensation.

# STATEMENT

# OF

# THE COMMITTEE OF ANNUITY INSURERS

# ON

# H.R. 2636

# THE TECHNICAL CORRECTIONS ACT OF 1987

The Committee of Annuity Insurers, a coalition of 26 of the Nation's leading annuity writers, appreciates the opportunity to offer comments on H.R. 2636, the Technical Corrections Act of 1987. The Committee of Annuity Insurers was formed in 1981 for the purpose of monitoring legislative and regulatory matters impacting the annuity company and the annuity policyholder. Enclosed for your information is a list of the member companies of our group.

Before offering specific comments on H.R. 2636, we would like to take this opportunity to commend the sponsors of this legislation, Chairman Rostenkowski and Congressman Duncan, and the staff of the Ways and Means Committee and the Joint Committee on Taxation. As introduced, the legislation goes a long way toward answering a number of critical questions on those provisions of the Tax Reform Act of 1986 impacting both nonqualified and qualified annuity contracts. To that end, we are most appreciative.

While we are supportive of the legislation as introduced, we would like to bring to the Committee's attention a number of additional issues which we feel should be addressed in any technical corrections legislation reported from your Committee. We believe that these proposed amendments are technical in nature and do not in any way alter the substantive provisions of the Tax Reform Act of 1986.

## Effective Date of Certain Penalty Tax Changes

In the Tax Reform Act of 1986, Congress made a number of changes to the penalty tax on premature distributions from nonqualified annuity contracts under section 72(q) of the Code. These changes included both an increase in the penalty tax from 5 percent to 10 percent and the elimination or revision of certain exceptions from such tax under the pre-1986 Code.

Before the 1986 Act, distributions made to a beneficiary (or to the estate of the annuitant) on the death of the annuitant were exempt from the penalty tax. However, the pre-1986 Code provided no exception from the penalty tax for distributions made upon the death of the holder even though section 72(s) of the Code required that an annuity contract contain language mandating distributions upon the death of the holder. Section 1826(c) of the 1986 Act corrected this problem by amending section 72(q)(2)(B) so as to provide that, in the case of distributions six months after date of enactment, the penalty tax will not apply to any distribution made on or after the death of the holder or, where the holder is not an individual, the death of the primary annuitant. The amendment deleted, however, the exception in pre-1986 law for distributions made on or after the death of the annuitant.

A problem develops insofar as the effective date of the new rule as a result of this deletion. As noted earlier, the repeal of the old exception for distributions made after the death of the annuitant and the imposition of the new exception for distributions made upon the death of the holder is effective for distributions made after April 22, 1987 (six months after date of enactment). As a result of the change, policyholders who were receiving distributions due to the death of the annuitant prior to April 22, 1987, and were continuing to receive distributions after such date, would be subject to a penalty tax. 1/ For example, assume policyholder A owns an annuity contract in which he is the holder and B is the annuitant. Under the terms of the contract (which was entered into prior to 1986), distributions must begin on the death of the annuitant. In December 1986, B dies. Policyholder A begins receiving benefits under the contract with payments to take place over a 3-year period. Since some of the distributions will be made on or after April 22, 1987, policyholder A will be subject to a 10 percent penalty tax on such distributions. Such a result appears highly inequitable.

In order to remedy this problem, we suggest an amendment to the "effective date" provision of section 1826(c) of the 1986 Act whereby the new exemption (and therefore repeal of the old) would be effective with respect to distributions commencing after April 22, 1987. We believe such an amendment would in no way change the substantive rule and would ensure that the intent of making the change apply prospective only is carried out.

## Applicability of Section 72(s) to Structured Settlement Annuities

In 1984, Congress amended section 72 of the Code so as to provide that an annuity contract, to be treated as such for purposes of the Code, must contain language specifying the methods of distribution in the event of the contractholder's death. Under these rules, as set forth in section 72(s) of the Code, the contract must provide that, if the contractholder dies before the annuity starting date, the entire interest will be distributed within 5 years after the date of death of the contractholder, or will be annuitized within one year after the date of death over a period equal to the life of the designated beneficiary (or over a period not exceeding the life expectancy of such beneficiary). In the event that the contractholder dies after the annuity starting date but before the entire interest in the contract has been distributed, the contract must provide that the remaining portion of such interest will be distributed at least as rapidly as the distribution method in effect as of

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1/ The Tax Reform Act of 1986 provided an exception from the penalty tax for certain distributions commenced as of March 1, 1986. Because of questions regarding the applicability of this exception to nonqualified annuities, section 111A(c)(23) of the Technical Corrections Act makes clear that the changes to the early withdrawal tax do not apply to any distribution under an annuity contract if (1) as of March 1, 1986, payments were being made under such contract pursuant to a written election providing a specific schedule for the distribution of the taxpayer's interest in such contract, and (2) such distribution is made pursuant to such written election. This exception would not be applicable, however, in the above case if the distribution on the death of the annuitant commenced after March 1, 1986.

the time of the contractholder's death. In the Tax Reform Act of 1986, Congress clarified the application of these so-called required distribution rules in cases where the contractholder is not an individual. Under section 72(s)(6), if the holder of the contract is not an individual (such as a corporate-owned annuity), the primary annuitant shall be treated as the holder of the contract for purposes of the required distribution rules.

A problem arises, however, as a result of the application of these revised required distribution rules to structured settlement annuities. In the case of structured settlement annuities issued after April 22, 1987 (the effective date of the primary annuitant required distribution rule), if the primary annuitant (i.e., the injured party) dies, the entire interest in such contract must be distributed in accordance with the rules set forth under section 72(s). However, section 130(c) of the Code requires that the stream of payments under a structured settlement annuity must be "fixed and determinable as to amount and time of payment" when the agreement is entered into and, further, requires that the payments under such contract, "cannot be accelerated, deferred, increased, or decreased by the recipient of such payments." As a result, it could be virtually impossible in some situations to comply with the required distribution rules of section 72(s) without violating the terms of the structured settlement contract and thus, section 130 of the Code. However, since section 130 of the Code requires a structured settlement annuity (i.e., a qualified funding asset) to be an "annuity contract", it would appear that failure to include the section 72(s) provision in the structured settlement annuity could mean that such contract would not be eligible for section 130 treatment.

There is no policy reason why such annuities should be subject to the required distribution-at-death rules. The very nature of a structured settlement annuity offers no way in which the payments may be prolonged beyond the originally agreed-to period. Furthermore, there would be neither an opportunity nor a motivation to extend tax deferral for additional periods if section 72(s) were not applicable to structured settlement annuities since such annuities are not subject to tax under section 104 of the Code.

Therefore, it is respectfully requested that the Technical Corrections Act of 1987 be amended so as to provide an exception from the section 72(s) required distribution rules for structured settlement annuities. Such a result could be achieved by adding the following new subparagraph to section 72(s)(5):

> "(D) which is a qualified funding asset (within the meaning of section 130(d), but without regard to whether there is a qualified assignment)."

## Treatment of Structured Settlement Annuities and Certain Corporated-Owned Annuities Under Alternative Minimum Tax

Section 72(u) of the Code provides that annuity contracts held by nonnatural persons (such as corporations) will not be treated as annuities for Federal income tax purposes and that the income (or inside build-up) on such contracts as determined under section 72(u)(2) will be taxed currently to the owner. However, Code section 72(u)(3) specifically provides five exceptions to the corporate-owned annuity provisions, including an exception for structured settlement annuities.

In section 701 of the Tax Reform Act of 1986, Congress added to the Code a new corporate alternative minimum tax ("AMT"). In order to ensure that all "profitable" companies would pay some tax on their economic income, Congress included as a preference item in the new AMT a book income adjustment preference for taxable years 1987 through 1989 and an adjusted earnings and profits preference for taxable years after 1989.

New Code section 56(g)(4)(B)(iii) provides that for purposes of calculating the earnings and profits of a corporation under the AMT the income on an annuity policy (i.e., the inside build-up), as determined under new Code section 72(u)(2), is includible in adjusted current earnings. A question has arisen, however, as to the interaction of section 72(u) with the earnings and profits calculation and, in particular, the applicability of section 56(g)(4)(B)(iii) to contracts specifically exempted from the corporate-owned annuity provision under section 72(u)(3).

Although section 56(g)(4)(B)(iii) does not specifically recognize the exceptions from the corporate-owned annuity provision (section 72(u)) for alternative minimum tax purposes, we believe there is no sound policy reason for providing inconsistent treatment.

The treatment of structured settlement annuities under the regular tax and the AMT aptly demonstrates this fact. New section 72(u)(3) excepts a "qualified funding asset" (as defined in section 130(d), and without regard to whether there has been a qualified assignment) from the current taxation of its inside build-up under the regular tax structure. An annuity that is a qualified funding asset is one under which the annuity payments match the payments to the injured party under a structured settlement liability. Because of this matching requirement, by definition, the holder of the contract (be it a structured settlement company or a property and casualty company) does not benefit or profit from holding an annuity contract that is a qualified funding asset.

Since the holder does not derive any economic benefit from the inside build-up on such a contract, it should not be included in the adjusted earnings and profits of the "holder" under the AMT. It is our understanding that including the income under such contracts as a preference item for purposes of the adjusted earnings and profits AMT was done under the mistaken belief that such treatment would conform to the treatment of such contracts under the book income preference item in years 1987 through 1989. However, the inside build-up on such contracts, under generally accepted accounting principles, is not reflected in the book income of the holder of the contract and thus is not included in the book income preference.

After analyzing the exceptions in section 72(u)(3), we believe that all such exceptions should be recognized for corporate alternative minimum tax purposes. For example, for reasons similar to those regarding the exception for a qualified funding asset, the income of an annuity that is purchased by an employer upon termination of a pension plan likewise should not be included in the AMT earnings and profits calculation of that employer.

We urge that an amendment be added to the Technical Corrections Act of 1987 to provide that section 56(g)(4)(B)(iii) will not apply to contracts described in section 72(u)(3).

Exchanges of Corporate-Owned Annuities

Section 72(u) of the Code, as added by the Tax Reform Act of 1986, provides that if an annuity contract is held by a person who is not a natural person (such as a corporation), then the contract is not an annuity contract for Federal income tax purposes and the income on the contract for any taxable year is treated as ordinary income received or accrued by the owner of the contract during the taxable year. The provision is effective for contributions to annuity contracts after February 28, 1986.

A question has arisen as to the treatment of a corporate-owned annuity which is received in a tax-free exchange under section 1035 of the Code for a corporate-owned annuity issued prior to March 1, 1986. In order that companies might properly account for such contracts, immediate guidance is needed.

The Committee of Annuity Insurers urges the Committee on Ways and Means to incorporate within the Technical Corrections Act of 1987 an amendment which provides that, in the case of a tax-free exchange under section 1035 of the Code, the replacement contract will retain the character of the contract given up in the exchange for purposes of applying the new corporate-owned annuity rules. Not only is such treatment in accord with the policy behind section 1035 of the Code, it is in keeping with the position taken in 1982 in a similar situation.

In the Tax Equity and Fiscal Responsibility Act of 1982 (the 1982 Act), Congress revised the annuity distribution rules of section 72(e) of the Code to provide, among other things, that amounts received before the annuity starting date would first be viewed as withdrawals of income credited to the contract to the extent of such investment income (a "LIFO" rule). The effective date of these provisions, like the effective date of the corporate-owned annuity provision in the 1986 Act, was geared to the date the investment was made in the contract. Thus, if the investment was allocable to the contract after the specified effective date (i.e., August 13, 1982) such investment was subject to the new LIFO rules. The new rules did not apply, however, to investments made prior to the effective date. In so doing, Congress specifically provided in the Conference Report accompanying the 1982 Act that "a replacement contract obtained in a tax-free exchange of contracts succeeds to the status of the surrendered contract. . . ." 2/

We believe that similar treatment should be accorded a tax-free exchange of a corporate-owned annuity. 3/

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2/ Rept. No. 97-530, 97th Cong., 2d Sess., at 647.

3/ We acknowledge that when Congress amended section 72 of the Code in 1984 so as to require annuity contracts to contain language specifying the methods of distribution in the event of the holder's death, they subjected the new contract issued in exchange for the pre-effective date contract to the new distribution-at-death rule. However, it should be noted that the effective date of the distribution-at-death rules was for contracts entered into after a specified date. Thus, in contrast to the changes made in 1982 to section 72(e) and in 1986 to section 72(u), investments allocable after the effective date to old contracts were not subjected to the new regime -- only totally new contracts.

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The Committee of Annuity Insurers is pleased to present its views on the Technical Corrections Act of 1987. We believe that the bill as introduced, along with the additional amendments which we have recommended herein, will provide much needed clarifications to our companies and our policyholders. Therefore, we urge enactment of this proposal at the earliest opportunity.

Respectfully submitted,

Gail Bramblett Wilkins

Gail Bramblett Wilkins

Counsel for
Committee of Annuity Insurers

## COMMITTEE OF ANNUITY INSURERS MEMBER COMPANIES

Aetna Life & Casualty Insurance Company
Allstate Life Insurance Company
American Express Company
American General Life Insurance
American International Group
Anchor National Life Insurance
Capital Holding Corporation
Church Life Insurance Corporation
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Sun Life of Canada
The Manufacturers Life Insurance Company
The Travelers Insurance Companies

ERIC

The
ERISA
Industry
Committee

August 18, 1987

COMMENTS ON THE
TECHNICAL CORRECTIONS BILL OF 1987
(H.R. 2636 AND S. 1350)

The ERISA Industry Committee ("ERIC") offers the following comments on the Technical Corrections Bill of 1987 (the "Bill").

1. PAYSOPs.

a. Plan Termination Exception to the 84-Month Rule. The Tax Reform Act of 1986 (the "Act") amended Code section 409(d)(1) to allow distributions upon the termination of a tax-credit ESOP (i.e., a PAYSOP) without regard to the 84-month rule prescribed by section 409(d). The legislative history of the Act makes it clear that this exception to the 84-month rule applies regardless of whether the employer securities held by the ESOP are distributed to plan participants or are transferred to another plan. See, e.g., Staff of Joint Comm. on Taxation, General Explanation of the Tax Reform Act of 1986, 100th Cong., 1st Sess. 715, 833-34 (1987) (the "Blue Book"). "Congress saw no purpose in restricting distributions or in otherwise limiting transfers or rollovers to other qualified plans upon plan termination." Id. at 834.

Notwithstanding the clear statement of Congressional intent in the legislative history, section 111B(i)(1) of the Bill would restrict the availability of the plan termination exception to cases in which (i) the distribution to every participant upon the termination of the PAYSOP is a lump-sum distribution and (ii) the employer does not establish a "successor plan" (a term that the Bill does not define).

The "lump-sum" restriction would prevent the plan termination exception from applying in many cases in which it was clearly intended to apply: where the securities are transferred directly to another plan upon the termination of the PAYSOP, where the employer maintains another stock bonus plan (which must be aggregated with the PAYSOP for lump-sum distribution purposes), or where, by design or inadvertence, the ESOP fails to distribute a single participant's account balance in one calendar year. Likewise, the Bill's introduction of the "successor plan" concept could, contrary to Congressional intent, prevent plan assets from being transferred directly to another plan. See Blue Book at 715, 833-34. In addition, according to some members of the Joint Committee staff, the "establishment of a successor plan" provision might prevent the plan termination exception from applying merely because the employer also maintains a pre-existing defined contribution plan (regardless of the fact that the pre-existing plan was "established" before the PAYSOP was terminated).

Since the proposed amendments conflict with the clearly expressed intent of Congress, they should be stricken from the Bill. Instead, the Bill should make clear that, in accordance with the legislative history of the Tax Reform Act, after a PAYSOP has been terminated, the employer securities held by the PAYSOP (or the proceeds realized upon the sale of those securities) may be transferred to another qualified plan and distributed from that plan without regard to the 84-month rule.

b. Participant Consent. Code section 411(a)(11) should be revised to provide that a terminating PAYSOP may distribute its assets to plan participants without first obtaining the consent of each participant.

As a result of the repeal of the PAYSOP credit, many PAYSOPs will be terminating within the next few years. In order to eliminate the cost of administering a dormant plan, many plan sponsors will wish to terminate their PAYSOPs and to distribute the PAYSOP assets to plan participants.

Section 411(a)(11) may prevent a terminating PAYSOP from making a mandatory distribution to any participant whose account balance exceeds $3,500. In view of the rollover opportunity that is available to the participant in these circumstances, and in view of the amendment to the 84-month rule in section 409(d) (which was clearly designed to facilitate plan terminations), a conforming change should be made to section 411(a)(11) (and to the corresponding provisions of ERISA) to permit the liquidation of terminating PAYSOPs.

A similar amendment should also be adopted to facilitate the termination of plans that accepted only qualified voluntary employee contributions. Since the Tax Reform Act eliminates the ability of a plan to accept such contributions in the future, it is appropriate to allow plan sponsors to terminate those plans whose only function was to accept voluntary employee contributions, without being constrained by participant (and spousal) consent requirements.

c. Distributions "in the Case of" Plan Termination. As it is now worded, the second sentence of Code section 409(d) provides that the 84-month restriction on the distribution of employer securities "shall not apply in the case of . . . death, disability, separation from service, or termination of the plan . . ." (emphasis supplied).

We urge that the phrase "in the case of" be deleted and replaced by the word "after" so that the second sentence of section 409(o) would state simply that the 84-month rule "shall not apply after . . . death, disability, separation from service, or termination of the plan" (emphasis supplied). The purpose of this change is to avoid making it necessary to establish a causal relationship between one of the specified events and the distribution in order for the distribution to qualify for the exception to the 84-month rule. This is likely to be a particularly troublesome issue in the case of a termination of a PAYSOP, since post-termination distributions may be made long after the plan has been terminated (especially if, contrary to ERIC's recommendation, participant consent is required in order to make the distribution).

Although it is clear that post-termination distributions should be exempt from the 84-month rule, the phrase "in the case of" might suggest that if there is too long an interval between the termination of the plan and the distribution, the 84-month rule will apply. In order to avoid this unintended and inappropriate reading of the statute, "after" should be substituted for "in the case of."

This amendment will be even more necessary if, contrary to ERIC's recommendation, the amendment to section 409(d) set forth in section 111(i)(1) of the Bill is adopted. Section 111(i)(1) would limit the plan termination exception to distributions "upon the termination of a plan." Since the word "upon" suggests a close proximity in time as well as a causal relationship, "upon" also should be replaced with "after" if this amendment is retained in the Bill.

d. Diversification Requirement. The Tax Reform Act added a new section 401(a)(28) to the Code. Section 401(a)(28) requires ESOPs and PAYSOPs to allow participants to diversify the investments allocated to their accounts as they approach retirement age. Because the diversification requirement imposes an entirely new obligation on employee stock ownership plans, the diversification requirement applies only to securities acquired after December 31, 1986.

It is now apparent that applying the diversification requirement to PAYSOPs makes no sense in light of the repeal of the tax credit for PAYSOP contributions as of the end of the 1986 tax year and in light of the fact that the diversification requirement applies only to securities acquired after December 31, 1986. In the case of a calendar-year taxpayer that maintains a calendar-year PAYSOP, the only securities subject to the diversification requirement would be the securities purchased in 1987 with the employer's contribution for the 1986 year and the securities purchased in 1987 and subsequent years with dividends received by the PAYSOP. If the employer made its 1986 contribution during 1986 or if the plan distributes dividends directly to participants in accordance with Code section 404(k), the diversification requirement has even less applicability.

The purpose of the diversification requirement is to permit a participant who is approaching requirement age to diversify the investment of a "major source" of his retirement savings. "Congress was concerned that employees for whom an ESOP provided a major source of retirement savings could be disadvantaged due to the fact that those savings could be invested exclusively in employer securities." Blue Book at 833 (emphasis supplied). However, the repeal of the PAYSOP tax credit makes it apparent that the securities purchased after 1986 under a PAYSOP will never represent a "major source" of a participant's retirement savings. Moreover, the costs of compliance with the diversification requirement will be substantial; the costs will include the cost of identifying and notifying the affected participants, the cost of processing participants' elections, and the cost of administering the diversification rule in conformity with the 84-month rule (which recognizes an exception only for the bare minimum number of shares that must be distributed in order to comply with the diversification requirement).

The minuscule benefits that the diversification requirement confers on PAYSOP participants clearly do not justify the costs of complying with that requirement. Accordingly, PAYSOPs that do not receive contributions for years after 1986 should be exempted from the diversification requirement.

e. Timing of Distributions. The Tax Reform Act added a new section 409(o) to the Code. Section 409(o) requires a PAYSOP to permit early distributions to participants who separate from service before normal retirement age. Under section 409(o), unless a participant otherwise elects, distribution of the participant's account balance under the plan must commence no later than one year after the close of a plan year (i) in which the participant separates from service by reason of the attainment of normal retirement age under the plan, disability, or death, or (ii) that is the fifth plan year following the plan year in which the participant otherwise separates from service unless the participant is reemployed by the employer before that year. This requirement applies only to distributions attributable to stock acquired after December 31, 1986.

The Bill should clarify the relationship between the early distribution requirements imposed by section 409(o) and the distribution rule prescribed by section 411(a)(11). Generally, under section 411(a)(11), as interpreted by the Service's temporary and proposed regulations, a plan may not begin to distribute a participant's interest in a plan before the earlier of age 62 or the participant's normal retirement age under the plan unless either the participant consents to the distribution or the value of the participant's nonforfeitable interest in the plan does not exceed $3,500. Thus, while section 409(o) appears to require an early distribution of plan benefits unless the participant elects otherwise, section 411(a)(11) appears to direct a delayed distribution of benefits unless the participant elects otherwise. Moreover, while section 411(a)(11) includes an exception where the participant's vested accrued benefit does not exceed $3,500, section 409(o) contains no such exception.

The Joint Committee's description of the Bill indicates that section 409(o) was intended to accelerate the otherwise applicable benefit commencement date. However, neither the Joint Committee's description nor the Bill makes clear that section 409(o) supersedes the provisions of section 411(a)(11). See Staff of Joint Comm. on Taxation, Description of the Technical Corrections Bill of 1987, 100th Cong., 1st Sess. 158-59 (1987).

ERIC recommends that the Bill resolve the conflict between these two provisions. In addition, ERIC urges that, to the extent that section 409(o) supersedes section 411(a)(11), a de minimis rule be adopted, so that PAYSOPs that do not accept employer contributions for years after 1986, will not be subject to the requirements of section 409(o). It makes little sense to apply section 409(o) solely to the stock that is purchased with employer contributions made during 1987 for the 1986 year (as well as to any stock purchased with reinvested dividends after 1986). In these circumstances, section 409(o) would apply only to a very small portion of the plan, while section 411(a)(11) would apply to the vast majority of the stock held by the plan. Accordingly, ERIC recommends that section 409(o) be amended so that it either (i) does not apply to a PAYSOP that does not accept employer contributions for any year after 1987 or (ii) does not apply where the employer securities purchased after 1986 have a value of $3,500 or less.

f. Lump-Sum Distributions. The Bill should clarify that section 409(o) permits a plan to make mandatory lump-sum distributions. As it is now worded, section 409(o)(1)(C) provides that unless the participant elects otherwise, the participant's account balance must be distributed "in substantially equal periodic payments (not less frequently than annually)" over a limited distribution period.

The purpose of this provision -- to encourage accelerated distributions from employee stock ownership plans -- would be advanced by permitting plans to make lump-sum distributions. Moreover, even as the statute is currently worded, a plan could satisfy the periodic payment requirement by making monthly payments during the course of a single taxable year. There is no justification for requiring a plan to go to the trouble of making monthly payments if the plan is able and willing to make a lump-sum distribution.

If section 409(o) were interpreted to require a plan to make periodic distributions over more than one taxable year, section 409(o) would deprive plan participants of the favorable capital gain, averaging, and rollover treatment accorded to lump-sum distributions as well as the favorable treatment given to lump-sum distributions of appreciated employer securities. Since there is no suggestion in either the language or the legislative history of the statute that section 409(o) was intended to have this effect, section 409(o) should be revised to make clear that mandatory lump-sum distributions are permissible.

2. Gift Tax.

Code section 2503(f) should be clarified to provide that a plan participant who does not (with his spouse's consent) waive a survivor benefit that is provided by the plan in accordance with the requirements of the Retirement Equity Act is not deemed, for gift tax purposes, to have made a transfer of property by gift to his spouse at the time when the spouse's right to the survivor benefit becomes irrevocable.

Since the survivor benefits required by the Retirement Equity Act are mandatory and can be waived only with the spouse's consent, the participant does not make a voluntary transfer of property in these circumstances. The gift tax does not apply to involuntary transfers. See Harris v. Commissioner, 340 U.S. 106 (1950); Estate of DiMarco v. Commissioner, 87 T.C. 653 (1986); but see LTR 8708008 (Nov. 21, 1986); LTR 8635031 (June 2, 1986).

This result is consistent with the addition of section 2503(f) to the Code. Section 2503(f) provides that if an individual waives any survivor benefits under the Retirement Equity Act, the waiver will not be treated as a gift.

If a spouse's affirmative waiver of a survivor benefit in favor of another beneficiary is not a gift, then a participant's passive acceptance of the requirements of Federal law is not a gift either. In short, neither the provision nor the waiver of a survivor benefit in accordance with the Retirement Equity Act should be treated as a gift for gift tax purposes.

3. Cash or Deferred Arrangements.

a. Business Dispositions. Section 401(k)(2)(B)(i)(III) and (IV) permits a cash or deferred arrangement to make distributions after a "sale by a corporation" of substantially all of the assets used in a trade or business with respect to an employee who continues employment with the "corporation" acquiring the assets and after a "sale by a corporation" of the corporation's interest in a "subsidiary" with respect to an employee who continues employment with the "subsidiary." Section 111(l)(1) of the Bill transfers these provisions to new Code section 401(k)(10) and appropriately expands the provisions to cover all dispositions and not just sales.

However, section 401(k)(10)(A)(ii) and (iii) should be revised to apply to unincorporated entities as well as to corporations. Since the business disposition provisions were not intended to distinguish between entities that are incorporated and those that are not, clauses (ii) and (iii) should be revised to make clear that they apply to unincorporated entities as well as to corporations.

For purposes of consistency, parallel changes should be made in Code section 409(d)(2) and (3) (pertaining to tax credit employee stock ownership plans).

In addition, in order to permit a pension plan to make distributions in the same circumstances, a parallel provision should be added to Code section 401(a) for pension plans.

b. Contingent Benefit Rule. The Tax Reform Act added a new section 401(k)(4)(A) to the Code to provide that a cash or deferred arrangement will not be qualified if any other benefit provided by the employer (other than a matching contribution) is contingent on the employee electing to have the employer make or not make contributions under the arrangement in lieu of receiving cash. The Blue Book states (at p. 642) that the contingent benefit rule is not limited to benefits provided under a qualified plan and that the employer could not condition the availability of health benefits on the employee's making elective deferrals under a cash or deferred arrangement.

The Bill should make clear that the contingent benefit rule does not prevent an employer from adopting a nonqualified "excess plan" that permits plan participants, whose ability to participate in a qualified cash or deferred arrangement has been restricted, either by the $7,000 limit imposed by section 402(g) or by the actual deferral percentage limit imposed by section 401(k), to defer additional compensation under a nonqualified arrangement.

We understand that the contingent benefit rule was designed to prohibit arrangements under which an employee's ability to participate in a qualified defined benefit plan was conditioned on his election to defer under a cash or deferred arrangement. Whatever the validity of that concern, it has no application to a nonqualified excess plan, which receives no tax-favored treatment and whose only purpose is to provide benefits on a nonqualified basis in circumstances where those benefits cannot be provided under a qualified plan. Neither the Tax Reform Act nor its legislative history contains the slightest suggestion that Congress intended to prohibit an employer from maintaining a nonqualified plan that provides those benefits that its qualified cash or deferred arrangement may not provide.

## 4. Excess Contributions.

Section 111(m)(11) of the Bill would amend Code section 4979(f)(2) to prescribe two rules regarding the taxation of excess contributions and excess aggregate contributions that are distributed within 2½ months after the end of the plan year. The rules provide that if the amount distributed is less than $100, it is treated as earned and received in the year in which it is distributed; on the other hand, if the amount of the distribution is $100 or more, it is treated as earned and received in the prior year. ERIC opposes the de minimis rule for distributions of less than $100.

The proposed de minimis rule would require the employer or plan administrator to distinguish between distributions that qualify for the de minimis rule and those that do not. Distributions of under $100 would be required to be reported on the appropriate form for the current year, while larger distributions would be required to be reported on the appropriate form for the prior year.

Meeting the extremely brief 2½ month deadline is difficult as it is. Requiring employers and plan administrators to take the additional step of distinguishing between small and large distributions will make the process even more difficult and is likely to prevent many plans from meeting the 2½ month deadline.

An appropriate alternative to the de minimis rule might be to require all distributions of excess contributions and excess aggregate contributions to be recognized in the year of distribution, but to require that an additional percentage of the excess (perhaps based on the current IRS interest rate) to be distributed at the same time in order to avoid giving participants an incentive to make excess contributions. Of course, the additional required distribution could not exceed the remaining balance in the participant's account under the plan.

### 5. Highly Compensated Employees.

Section 111(j)(3)(B) of the Bill amends Code section 414(q) to provide that for purposes of identifying an employer's "highly compensated employees" and for purposes of applying the rules regarding separate lines of business, employees who are nonresident aliens and receive no U.S. source earned income from the employer shall not be treated as employees. This provision appears to be intended to respond to ERIC's earlier request that section 414(q) be amended to provide that nonresident aliens "may be" disregarded for purposes of identifying the employees in the top-paid group. However, ERIC's request was that an employer be permitted to disregard nonresident aliens for this purpose, not that it be required to do so. In certain instances an employer may wish to take nonresident aliens into account for purposes of identifying the employees in its top-paid group. There appears to be no justification for preventing an employer from doing so. Accordingly, ERIC recommends that section 111(j)(3)(B) be revised to make the proposed rule regarding nonresident aliens permissive rather than mandatory.

### 6. Taxation of Distributions.

a. Basis Recovery - Pre-Annuity-Starting-Date Distributions. Section 1122(c)(3) of the Act generally provides for basis recovery under a pro rata rule in the case of amounts not received as annuities. The rule applies retroactively to distributions made after July 1, 1986. The Conference Report indicates that "a separate account of a defined benefit plan (and the income attributable thereto) are treated as a separate contract for purposes of section 72 and application of the pro rata rule." *See* H.R. Rep. No. 841, *supra*, at II-462. However, in Notice 87-13 (Q&A-13) the Internal Revenue Service took the position that if employee contributions to a defined benefit plan are credited with a stated rate of interest, such employee contributions (and the earnings thereon) are not treated as a separate contract for purposes of section 72(e)(9). As a result of the Service's position, employee contributions to a typical contributory defined benefit plan are not eligible for separate contract treatment, since such plans typically credit employee contributions with a specified rate of interest. Furthermore, although Code section 72(e)(8)(D) establishes a transition rule that exempts pre-1987 employee contributions from the new pro rata rule in the case of a plan that, on May 5, 1986, permitted the withdrawal of employee contributions *before separation from service*, section 72(e)(8)(D) will not provide relief to the participants in typical contributory defined benefit plans that do not permit distributions or withdrawals *until* the participant separates from service.

In view of the retroactive effective date of the new basis recovery rules, and the inapplicability of the section 72(e)(8)(D) transition rule to contributory defined benefit plans, the new rules have a harsh and unanticipated effect on many participants in contributory defined benefit plans who retired between July 1, 1986, and December 31, 1986. Many of these participants elected, in accordance with the terms of their plans, to receive refunds of their prior contributions and the earnings thereon, after they had separated from service, but before their employer-provided pension commenced. Virtually all of these participants made their decisions to withdraw their contributions (and earnings) on the assumption that the withdrawals would be taxed in accordance with prior law. Had they known of the retroactive change in the basis recovery rules, many would never have elected to make a withdrawal; others would have elected to roll over the taxable portion of their withdrawal into an IRA or qualified plan. Under current law, it is too late for these participants to reverse their decisions. The withdrawals have been made, and the 60-day rollover period has expired.

In many cases, the change in the law has a strikingly punitive effect. One of ERIC's members has determined that the increase in the employee's taxable income resulting from the change in the basis recovery rule has more than doubled in a number of instances. The same member has found that the group of employees harmed were primarily employees whose jobs were eliminated during 1986 and that the overwhelming majority of these employees were from the hourly and nonexempt salaried ranks. ERIC believes that these employees have been unjustly and unintentionally harmed by the retroactive application of the basis recovery rules to contributory defined benefit plans.

Section 111A(a)(11) of the Bill provides relief from this unjust result, but only for participants in plans maintained by States. Section 111A(a)(11) adds a new paragraph (9) to section 1122(h) of the Tax Reform Act that applies to a plan maintained by a State that, on May 5, 1986, provided for employee withdrawals of employee contributions in a form other than an annuity. Under the Bill, pre-annuity-starting-date distributions from such a plan are subject to the Act's new basis recovery provisions only to the extent that the amount distributed exceeds the employee's basis under the plan as of December 31, 1986. In addition, for this purpose, amounts received (other than as an annuity) before or with the first annuity payment are treated as having been received before the annuity starting date.

However, while section 111A(a)(11) eliminates the punitive effects of the Act's retroactive change in the basis recovery rules for State employees, it does nothing to alleviate the harsh results for employees in the private sector. There is no justification for such discrimination against private sector employees, particularly in the context of a Tax Reform Act that sought to add greater equity to the income tax system.

Accordingly, section 111A(a)(11) should be amended to eliminate completely the harsh effects of the retroactive change in the basis recovery rules and to provide equal treatment to public-sector and private-sector employees.

b. Basis Recovery - Annuity Refund Feature. Section 72(c)(2) of the Code (both before and after the Act) provides for a reduction in the investment in the contract equal to the discounted value of any refund feature provided under the contract. ERIC recommends that section 72(c)(2) be repealed.

Prior to the enactment of new Code section 72(b)(2) -- which limits basis recovery under the exclusion-ratio method to the taxpayer's unrecovered investment in the contract -- there might have been some logic to the reduction required by section 72(c)(2); since it was possible that the taxpayer could recover more than 100 percent of his investment in the contract by outliving his life expectancy, it might have been appropriate to reduce his investment in the contract to reflect the offsetting possibility that the taxpayer might die prematurely and that his investment in the contract would be recovered in the refund to the beneficiary pursuant to section 72(e)(5)(E).

With the enactment of section 72(b)(2), there is no longer any possibility that the taxpayer will recover more than 100 percent of his investment. Accordingly, there is no longer any justification for making the adjustment required by section 72(c)(2). Moreover, if section 72(c)(2) is not repealed, it will effectively preclude full recovery of the taxpayer's investment in the contract except in the case where his premature death results in the payment of a refund. Moreover, the adjustment required by section 72(c)(2) is extremely complex and can be made only by an actuary or someone trained in higher mathematics. See Treas. Reg. § 1.72-7(c)(1). The repeal of section 72(c)(2) would thus advance the Tax Reform Act's objective of simplifying the Code.

c. Small Distributions. Section 72(t)(2) should be revised to provide that the tax on early distributions does not apply to a participant to whom a plan makes a lump-sum distribution of $3,500 or less following the participant's separation from service. Although the literal language of the statute does not now include such an exception, the Conference Report indicates that the conferees intended to create this exception. See H.R. Rep. No. 841, supra, at II-456.

ERIC understands that at least some members of the staff believe that the current provisions of the bill are correct and that it is the Conference Report that is in error. This view is reflected in section 111A(c)(13) of the Bill, which provides that the tax on early distributions applies to involuntary cash-outs.

However, ERIC believes that it is appropriate to exempt small distributions from the section 72(t) tax. Although the recipient of a large taxable distribution can roll over the distribution and therefore avoid the additional tax, many IRA sponsors are unwilling to accept small deposits. Accordingly, ERIC believes that it is appropriate to establish an exception for small distributions. Since Congress has previously recognized $3,500 as the appropriate ceiling for small distributions, ERIC urges that, in the interests of simplicity and consistency, $3,500 should be the cutoff point under section 72(t) as well.

d. Net Unrealized Appreciation. As amended by the Tax Reform Act, Code section 402(e)(4)(J) permits a taxpayer to elect not to have section 402(e)(4)(J) apply with respect to a distribution of appreciated employer securities. By making this election, a taxpayer may recognize all of the income attributable to the appreciated employer securities and to forego the exclusion that is otherwise available for the net unrealized appreciation attributable to those securities.

Section 111A(b)(7) of the Bill corrects two technical errors that appear in Code section 402(e)(4)(J) by changing the phrase "this paragraph" to "this subparagraph" and by allowing the taxpayer to make the election on the tax return in which the distribution is required to be included in gross income if the election is made.

However, an additional technical error in section 402(e)(4)(J) also requires correction. Section 402(e)(4)(J) should be revised to provide that the taxpayer may elect to have this subparagraph and the second and third sentences of section 402(a)(1) apply to the distribution. The second and third sentences of section 402(a)(1) would otherwise require a portion of the net unrealized appreciation to be excluded from the taxpayer's gross income -- contrary to the purpose of the election offered by section 402(e)(4)(J).

e. Section 1124 Election. Section 1124 of the Act and section 402(e)(4)(B) of the Code should be clarified to provide that an election under section 1124 to treat a 1987 lump-sum distribution as though it had been received in 1986 will not be treated as an election made under section 402(e)(4)(B) after December 31, 1986.

The purpose of section 1124 is to permit an employee who separated from service or became disabled before 1987, but who did not receive his lump-sum distribution until 1987, to treat the distribution as though he had received it in 1986. Section 1124 reflects the Congressional judgment that the employee in these circumstances should not be adversely affected by the Tax Reform Act merely because of the delay in distributing a lump-sum distribution following his separation from service. As a result, Congress could not have intended that an election under section 1124 would be treated as a post-1986 election for purposes of section 402(e)(4)(B), since such treatment would thwart the clear objectives of section 1124.

In Notice 87-13 (Q&A-24), the Internal Revenue Service took the position that an election under section 1124 would be treated as a post-1986 election under section 402(e)(4)(B). The Bill should make clear that the Service's position is erroneous.

Section 111A(d)(3) of the Bill adds a new section 1124(c) to provide, in part, that for purposes of section 1124, the term "lump-sum distribution" has the meaning given to that term by Code section 402(e)(4)(A), without regard to section 402(e)(4)(B) (which contains the election requirement). The Bill should clarify that, as a result of this provision, a taxpayer who has made a section 1124 election will not be barred from making an election in the future under section 402(e)(4)(B).

f. Excise Tax on Excess Distributions. Section 111A(g)(5) of the Bill would add a new paragraph (5) to Code section 4980A(d) to permit a spouse who is the beneficiary of all of the interests in a deceased employee's retirement plans to elect (i) not to have the special additional estate tax apply and (ii) to have all of the distributions received by the spouse in respect of the deceased employee aggregated with the spouse's own distributions for purposes of applying the general excise tax on excess distributions.

ERIC recommends a technical correction to this rule. Many individuals, fearing their spouse's improvidence, make their retirement benefits payable to trusts for the benefit of their spouses. This common estate planning technique was recognized and accommodated in Code section 401(a)(9)(B)(iii)(I), which recognizes that payments may be made, for the life of a beneficiary, to or "for the benefit of" the beneficiary. A similar provision should be added to section 4980A(d)(5) to permit the election to be made if the spouse and/or trusts for the benefit of the spouse are the beneficiaries of all of the interests in the deceased employee's retirement plans.

g. Additional Estate Tax. Unless a technical correction is made, the additional estate tax imposed by section 4980A(d) may be erroneously applied twice to the same distribution. This result occurs because the tax applies to "the value of the individual's interests in qualified employer plans and individual retirement plans as of the date of the decedent's death." As a result, if, for example, a participant's spouse is the beneficiary of the participant's plan benefits and delays receiving a distribution from the plan or rolls over a distribution into an individual retirement account (and the spouse does not make the election described in the two preceding paragraphs), the additional estate tax could be imposed both at the time of the participant's death and again at the time of the spouse's death. Since section 4980A is clearly designed to impose the additional tax once and only once, the Bill should correct this technical error in section 4980A(d).

7. Integration.

a. Career Average Plans. Code section 401(l)(4)(C)(i) should be revised to permit a career average plan to use an integration level exceeding covered compensation.

Section 401(l)(4)(C)(i) requires the Treasury to reduce the 3/4 percentage factor used in calculating the maximum excess allowance (or the maximum offset allowance in the case of an offset plan) where an excess plan has an integration level exceeding covered compensation (or with respect to any participant in an offset plan who has final average compensation exceeding covered compensation). Section 405(l)(5)(E)(i) defines "covered compensation" as "the average of the contribution and benefit bases in effect under section 230 of the Social Security Act for each year in the 35-year period ending with the year in which the employee attains age 65."

If it is appropriate to limit the integration factor for a final average plan by reference to "covered compensation," it is inappropriate to limit the integration factor for a career average plan by reference to "covered compensation." In the case of the final average plan, all of the participant's pension benefit is based on the participant's final earnings. In the case of a career average plan where each year's earnings count toward the participant's benefit, the integration levels for the earlier years' earnings might be at very low levels reflecting the social security compensation and benefit levels in effect in those years, while the later years' earnings would typically be at higher integration levels, reflecting the social security compensation and benefit levels in effect in those years. If the integration level used for each year under a career average plan is limited to the then current 35-year average of the social security compensation and benefit bases, the Act would impose a much more restrictive limit on integration for career average plans than for final average plans. Contrary to the assertion in the Blue Book (at p. 697), we believe that Congress did not intend any such result. Accordingly, we recommend that section 401(l)(4)(C)(i) be amended by adding the following:

> "No reduction shall be made pursuant to this clause (i) if benefits are based on the participant's earnings in each year of participation, and the integration level with respect to each year does not exceed the limitation described in paragraph (5)(A)(ii) for each such year."

A career average plan with an integration level with respect to compensation for each year equal to the compensation and benefit base under social security then in effect would produce an ultimate level of integration comparable to that of a final average pay plan with "covered compensation" as the integration level, since covered compensation would represent the average of the social security bases over a 35-year period. Accordingly, the Code should be revised to reflect our recommendation.

b. Simplification of Reduction in Maximum Allowances. Code section 401(l)(5)(F)(i) should be revised to simplify the required reductions in the maximum excess and offset allowances.

Section 401(l)(5)(F)(i) instructs the Treasury to prescribe rules for reducing the maximum excess allowance and the maximum offset allowance in the case of a defined benefit plan that provides for unreduced benefits commencing before the social security retirement age as defined in section 415(b)(8). Since there are three different retirement ages under social security (65, 66, and 67), depending on the employee's date of birth, there would have to be three sets of benefit formulae under the plan in order to reflect the reductions for employees in the three age groups.

To implement Congress' stated goal of simplifying the integration rules, we recommend that section

401(l)(5)(F)(i) be amended by striking the words "the social security retirement age (as defined in section 415(b)(8))" and inserting in lieu thereof the words "age 65." Congress considered it appropriate to use age 65, rather than social security retirement age, for purposes of calculating "covered compensation" (see Code section 401(l)(5)(E)); and we know of no policy reason why age 65 should not also be used in reducing the maximum allowances to reflect unreduced early retirement benefits.

ERIC opposes section 111(g)(3) of the Bill, which would amend Code section 401(l)(5)(E) by substituting "social security retirement age" for "age 65" for purposes of calculating "covered compensation." This change would further complicate the calculation of "covered compensation" and would interfere with the goal of simplifying the integration rules.

8. Title-Holding Companies.

The Tax Reform Act added a new section 501(c)(25) to the Code to exempt certain corporations and trusts organized to acquire and hold title to real property, to collect the income from the property, and to remit the income therefrom (less expenses) to one or more specified categories of tax-exempt organizations (including qualified pension, profit-sharing, and stock bonus plans) that are the shareholders of the corporation or beneficiaries of the trust.

Since section 501(c)(25) states explicitly that the functions of the title-holding company include the collection of income, the payment of expenses, and the distribution of the remaining income, it is implicit that the organization may hold the cash or cash equivalents that are the necessary incidents of these activities. However, the Joint Committee staff's description of the Bill states that "a section 501(c)(25) title-holding company may only hold real property" and (if the Bill is enacted) certain personal property that is leased under, or in connection with, a lease of real property. See Staff of Joint Comm. on Taxation, Description of the Technical Corrections Bill of 1987, 100th Cong., 1st Sess. 280 (1987).

The Internal Revenue Service has recognized that a section 501(c)(2) title-holding company may retain part of its income each year to apply to indebtedness on property to which it holds title. See Rev. Rul. 77-429, 1977-2 C.B. 189. There is no justification for treating a section 501(c)(25) title-holding company less favorably than a section 501(c)(2) title-holding company in this respect. Accordingly, the Bill should clarify that a section 501(c)(25) title-holding company may retain income to defray its expenses.

9. Buy-Back Rights.

The Bill should clarify that a plan may require the repayment of a withdrawal made on account of an employee's separation from service before the close of the first period of five consecutive one-year breaks in service commencing after the date of the separation from service.

Section 1898(a)(4) of the Act amended Code section 411(a)(7)(C) and ERISA section 204(e) to provide that a plan may require the repayment of a withdrawal made on account of separation from service before the close of the first period of five consecutive one-year breaks in service commencing after the date of the withdrawal. Under Treas. Reg. § 1.411(a)-7(d)(4), a withdrawal is deemed to be made on account of an employee's separation from service if it is made not later than the close of the second plan year following the plan year in which the separation occurs. Accordingly, an employee might have incurred as many as three consecutive one-year breaks in service on the date of his withdrawal.

If the employee is permitted to repay such a withdrawal at any time before the close of five consecutive one-year breaks in service commencing after the date of the withdrawal, the employee will be able to make the repayment (and thus to "buy back" the forfeitable portion of his accrued benefit) at any time before he has incurred a total of eight consecutive one-year breaks in service. This provision is inconsistent with section 411(a)(6)(C) of the Code, which permits a plan to provide that the nonforfeitable percentage of the benefit accrued prior to the employee's separation from service will not increase after he has incurred five consecutive one-year breaks in service. The suggested technical correction would conform the repayment rule in section 411(a)(7)(C) to the vesting rule in section 411(a)(6)(C).

10. Technical Corrections to COBRA.

a. Foreign Plans. The Act amended the definition of "qualified beneficiary" in Code section 162(k)(7)(B)(iii) to exclude any individual whose status as a covered employee is attributable to a period during which the individual was a nonresident alien receiving no earned income from sources within the United States. However, the amendment failed to address the case of a United States citizen who is employed by a foreign affiliate of a United States company and who is covered by a foreign medical plan. Unless a technical correction is adopted to address this situation, the foreign medical plan will be required to provide health care continuation coverage to the United States citizen and his dependents. This result clearly was not intended by Congress and is inconsistent with the provision that appears in ERISA (but not in the Code) which exempts plans maintained outside of the United States primarily for the benefit of persons substantially all of whom are nonresident aliens. See ERISA § 4(b)(4).

In order to avoid an inconsistency between the health care continuation provisions of the Code and the health care continuation provisions of ERISA, the Bill should amend the Code to create a parallel exemption for foreign plans. Large multinational companies are often not aware of the number and identity of the United States citizens working abroad for their foreign affiliates. This is particularly true where the United States citizen is hired abroad and is not a transferee from a domestic affiliate. There is no suggestion in either the statute or the legislative history that Congress intended to extend COBRA protection to employees who work abroad. Indeed, section 4(b)(4) of ERISA strongly indicates that Congress intended not to provide such protection.

As a practical matter, it is difficult to imagine how multinational companies will be able to teach their plan administrators around the world to understand the COBRA regulations and to send timely COBRA notices to their nonresident United States citizen employees and their dependents. There is absolutely no reason to believe that Congress intended to impose these burdens on foreign plan administrators or to impose draconian penalties on multinational companies in the event of a single default by a foreign plan administrator. Accordingly, the Bill should amend section 162(k)(7)(B)(iii) to eliminate the inconsistency between the Code and ERISA.

b. Controlled Group Rules and COBRA Sanctions. Section 111B(a)(17) and (19) of the Bill would apply COBRA's health care continuation requirements on a controlled group basis. As a result, a single violation of the COBRA requirements by a plan to which one member of a controlled group of corporations contributes causes all of the members of the group to lose all of their deductions for contributions to all of their group health plans. In addition, all highly compensated employees of the controlled group lose the benefit of the exclusion for employer-provided group health benefits unless all of the group health plans maintained by the controlled group satisfy the COBRA requirements.

ERIC believes that the sanctions imposed for noncompliance for COBRA are excessive. When these excessive sanctions are imposed on a controlled group basis, the sanctions become nothing less than an exercise in overkill. A large controlled group of corporations with thousands of employees could lose hundreds of millions of dollars in tax deductions merely because one small affiliate failed, perhaps inadvertently, to comply with COBRA. Moreover, all highly compensated employees in the controlled group in this situation would lose the benefit of the exclusion for employer-provided group health coverage merely because of actions that were totally beyond the control of all but a handful of those employees.

Accordingly, ERIC urges that the COBRA sanctions not be applied on a controlled group basis and that the statute be amended to waive the sanctions where the violations of COBRA are isolated, the result of a good faith effort to comply, or are corrected on a retroactive basis.

11. Technical Corrections to the Tax Reform Act of 1984.

Section 1852(h)(1) of the Tax Reform Act of 1986 made a technical amendment to section 528 of the Tax Reform Act of 1984.

The 1984 Act required that amounts contributed to a section 401(h) arrangement for plan years beginning after March 31, 1984, for retiree health benefits with respect to a five-percent owner must be (i) maintained in a separate account and (ii) treated as "annual additions" for purposes of the limits under Code section 415.

The 1984 Act added a similar requirement to section 419A of the Code for contributions paid or accrued after December 31, 1985, in plan years ending after that date, with respect to key employees.

The technical correction in the 1986 Act sought to eliminate the inconsistency between sections 401(h) and 419A by amending section 401(h) to make it apply to key employees rather than to five-percent owners. However, in eliminating one inconsistency, the Bill created another, since the change was made effective retroactively to plan years beginning after March 31, 1984 (the effective date of the original section 401(h) separate account requirement for five-percent owners) rather than for contributions paid or accrued after December 31, 1985 (the effective date of the section 419A separate account requirement for key employees).

There is no justification for the earlier retroactive effective date. If the objective is to treat key employees in the same manner under section 401(h) as under section 419A, the effective date for section 401(h) arrangements should be identical to the effective date for section 419A plans. Moreover, adopting a retroactive effective date for section 401(h) arrangements creates serious practical problems; the retroactive change in the law could cause an employee to exceed the section 415 limits retroactively, long after the employer had a timely opportunity to correct the problem. An excess annual addition would be particularly difficult to correct if the employee has already separated from service or has died.

We urge that the Bill be amended to change the effective date of section 1852(h)(1) of the 1986 Act to plan years beginning after December 31, 1986. If this is not acceptable, the effective date should at least be changed to be no earlier than the effective date of the separate account rule under section 419A (contributions paid or accrued after December 31, 1985, in plan years ending after that date).

# WRITTEN COMMENTS ON H.R. 2636
# THE TECHNICAL CORRECTIONS ACT OF 1987
# TO THE HOUSE WAYS AND MEANS COMMITTEE

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Mr. Chairman and members of the House Ways and Means Committee, the ESOP Association is generally pleased with those provisions of H.R. 2636 which make techical and clarifying changes to provisions of the Tax Reform Act of 1986 (TRA 86) that affect the establishment and administration of Employee Stock Ownership Plans (ESOPs).

Since passage of TRA 86, the ESOP Association has submitted comments on the ESOP provisions to the tax professionals of the Treasury Department, the IRS, the House Ways and Means Committee, the Senate Finance Committee, and the Joint Committee on Taxation. Many of these comments have been addressed in IRS announcements and guidelines on TRA 86, the "Blue" Book and in H.R. 2636. Several have not yet been addressed, and several new matters have since been called to our attention.

As usual, your professional and clerical staff have received our comments in a most professional manner.

Anytime a massive piece of legislation like TRA 86 becomes law, very technical questions, and even disagreements, arise over the meaning of the language of the law. And it is understood by all that, despite good faith efforts by Congress, its staff, the Executive Branch and its professionals, the Judiciary and private commentators, some questions and some disagreements over language and meaning will never be resolved.

In this spirit, the ESOP Association has commented on approximately 40 different provisions of TRA 86 since its enactment.

The ESOP Association now submits comments on H.R. 2636. Some are new comments arising from provisions of H.R. 2636, and some are repetitions of comments provided earlier, where an amendment or clarification is still needed, or modified where the subject matter is addressed by H.R. 2636.

## ATTACHMENT

### ESOP comment 1

Section 111A(c)(2) of H.R.2636, relating to section 1123 of TRA 86; Code section 72(t)(2).

Background: This paragraph of H.R. 2636 completely rewrites the original provisions of TRA 86 that provide for an exemption from the 10% early withdrawal tax for certain distributions from an ESOP. The ESOP Association opposes the H.R. 2636 rewritten version because: (1) it adds a new substantive requirement in order for an ESOP distribution to be exempted from the 10% early withdrawal tax; (2) the new substantive requirement has no basis in the legislative history pertaining to TRA 86 Section 1123; and (3) the justifiable confusion over the exact meaning of Code section 72(t)(2)(C) may be significantly cleared up with a minor amendment, plus guidance from the Blue Book, IRS Announcement 87-13, and subsequent IRS regulations and guidelines.

Problem: Section 111A(c)(2)provides that in order for an ESOP distribution to be exempt from the 10% early withdrawal tax, 2 tests must be met. The second test is a requirement not in current law that the distributed employer securities must have met at all times in the 5 years prior to distribution the requirements of Code section 401(a)(28) (the ESOP diversification rule) and Code section 409 -- which currently contains rules for both leveraged and tax-credit ESOPs, as well as to a lesser extent stock bonus plans. (We assume that the employer securities in existence prior to January 1, 1987, need not comply with ESOP rules effective post-TRA 86 enactment. For example, section 401(a)(28) does not apply to employer securities acquired in 1984. If those securities were distributed in 1988, the recipient should qualify for the ESOP exemption, if all other requirements were met. If the ESOP Association assumption is wrong, then §111A(c)(2) is a partial repeal of the effective dates of the new ESOP rules included in TRA 86.) This new requirement is harsh because it eliminates the exemption for employer securities distributed from a leveraged and non-leveraged ESOP because their employer securities were not held under the rules of section 409 of the IRC of 1954 (because section 409 of the 1954 I.R.C. primarily contained rules applicable to tax credit ESOPs). For example, under section 409, tax-credit ESOPs are required to vest immediately, to comply with the 84-month rule, and to make allocations based on no more than $100,000 in compensation. Other ESOPs have never been required to comply with these rules.

Furthermore, section 111A(c)(2) does not allow a distribution from an ESOP to qualify for the exception if the employer securities were transferred, or "converted" from a prior qualified plan to the distributing ESOP, because the "converted" plan could not, or would not, meet the requirements of sections 401(a)(28) and 409.

The Conference Report clearly intends that employer securities from converted plans qualify for the ESOP exception:

> "In a case in which a plan is converted to an ESOP, plan assets must have been so invested for 5 plan years prior to distribution...Tacking of investment periods is permitted." (pp. II-457-458 of Conference Report).

The Blue Book also sets forth an intent that tacking from one plan to another is permitted if assets transferred were invested in employer securities in the predecessor plan. (p.718).

But the new requirement of complying "at all times" (i.e., for the 5 years preceding the distribution) with the rules of sections 401(a)(28) and 409 designed strictly for ESOPs, and mainly tax-credit ESOPs prior to 1987, makes transfers ineligible for the ESOP exception.

Finally, the criticism of current law 72(t)(2)(C) has always focused on the words "at all times", which is an absolute term. In the real world, very few things occur "at all times" and this is particularly true of an ESOP. Frequently the ESOP receives cash from the plan sponsor which it uses to buy employer securities. Unless the purchase is instantaneous (which it seldom is), the plan would not comply with a strict "at all times" interpretation. Similarly, an ESOP trustee may invest a portion of plan assets in cash equivalents in order to assure sufficient plan liquidity to meet repurchase liability. Both actions may be prudent trustee actions. Also, a corporate restructuring may result in an existing ESOP holding securities of the new spin-off corporation.

Current law ameliorates the "at all times" language by also setting forth in the general rule for the exception that "on the average, a majority of assets in the plan have been invested in employer securities". Although the "on the average" and "at all times" language do not directly discuss the same rule in current law, the use of "on the average" indicates an intent to reflect in the statute a realistic understanding of ESOP assets.

Section 111A(c)(2), however, drops the reasonable language and proceeds to use "at all times" twice. If enacted as drafted, it would seem to repudiate IRS Announcement 87-13, Q&A 21, which tries to interpret the "at all times" requirement in a more reasonable manner recognizing that it is impossible to meet a literally interpreted "at all times" test.

Solution: Amend only current law clause (ii) of §72(t)(2)(C) to give the IRS regulatory authority to apply the "at all times" test reasonably. Do not adopt the H.R.2636 version of 72(t)(2)(C).

Suggestion: Amend Subsection 1123(a) of TRA 86 (Code section 72(t)(2)(C)) to read as follows (added words underlined and deleted words stricken through):

(C) Certain plans -
(i) In General. - Except as provided in clause (ii), any distribution made before January 1, 1990, to an employee from an employer stock ownership plan defined in section 4975(e)(7) or section 409(a) to the extent that, on average, a majority of assets in the plan have been invested in employer securities (as defined in section 409(l) for the 5-plan-year period preceding the plan year in which the distribution is made.

(ii) Benefits Distributed Must Be Invested in Employer Securities For 5 Years. - Clause (i) shall not apply to any distribution which is attributable to assets which have not been invested in employer securities during the period referred to in clause (i) except as provided in regulations prescribed by the Secretary."

In addition, the Committee Report should provide guidance with several examples, including language indicating that (1) a de minimus amount may be held in cash; (2) cash contributions including cash dividends (interim cash) need not be invested in employer securities for a reasonable period of time; and (3) certain corporate reorganizations may result in the replacement of employer securities for a reasonable period of time, taking into account all the facts and circumstances of the reorganization.

Justification: Although the ESOP exception to the early withdrawal tax is to expire January 1, 1990, it is an important ESOP provision because of the early distribution requirement imposed on ESOPs and the concept behind employee ownership that capital ownership produces a supplemental income for a wage earner. Thus, the ESOP Association wants the provision to operate smoothly and effectively as intended by Congress. The recommended changes are in line with the Conference Report (i.e., conversion/transfers qualify and plans in existence less than 5 years qualify), the IRS Announcement 87-13 (tax-credit ESOPs qualify), and the Blue Book (tacking allowed), except for the specific grant of regulatory power to the Secretary. The Committee Report could set forth the intent that the "at all times" language be applied in a reasonable manner, that "tacking" is permitted, and that for plans in existence less than 5 years, the period of existence of the plan is treated as the 5-year plan period.

**ESOP Comment 2:**

Section 111A(f)(2) and (3) of H.R.2636, amending section 1132 of TRA 86; Code section 4980(c)(3).

Background: TRA 86 exempts certain excess reversions from a terminated defined benefit plan from the new excess reversion excise tax if they are transferred to an ESOP.

Problem: Current law requires that the employer securities acquired with the excess reversions stay in the ESOP until distributed in accordance with the plan. This requirement may block a prudent action by the plan trustee (e.g., in the case of a sale of stock). Also, it would help to clarify that a plan sponsor can contribute to another ESOP in order to amortize an ESOP loan, provided that allocations under the combined plans do not breach the 415 limits. Finally, paragraph (3) of section 111A(f) uses the word "amount", which may create confusion if the value of the employer securities appreciate or decline.

Solution: Provide that the Secretary may waive the requirement that securities remain in the ESOP until distribution in accordance with plan, and clarify that the employer may contribute to another ESOP as long as the 415 rules are not breached. Finally, change the word "amount" so that the one-eighth minimum allocation is measured by numbers of shares.

Suggestions: (1) Amend current law section 4980(c)(3)(A)(ii) and (II) to read as follows (new words underlined):

> "(ii) Under the plan, employer securities to which subparagraph (B) applies must remain in the plan until distribution to

participants in accordance with the provisions of such plan. The Secretary may waive the requirement of this clause."

(2) Amend subparagraph (B) of section 111A(f)(3) of H.R.2636 to read as follows (new words underlined and deleted words stricken through):

> "(B) by adding at the end thereof the following new sentence:
>
> 'The amount allocated in the year of transfer shall not be less than the lesser of the maximum ~~amount~~ number of employer securities allowed under section 415 or 1/8 of the total ~~amount~~ number of employer securities transferred.'"

(3) Clarify in the Committee Report on H.R. 2636 that the operable limitation on ESOP contributions utilizing section 4980 is section 415. This clarification could be provided by using the Blue Book explanation:

"The amounts held in the suspense account that can be required to be allocated each year are to be allocated to participants' account before any other employer contributions are allocated. In other words, during the period that reversion amounts are held in a suspense account, the employer is not permitted to make additional contributions to the ESOP or any other plan to the extent that the contributions, when added to the amounts held in the suspense account which are required to be allocated each year, would exceed the overall limits on annual additions under a defined contribution plan if allocated to participants' accounts." (p. 753).

Justification: If the release of stock is within applicable 415 limits, there is no reason to prevent the release of stock in a leveraged ESOP in order to amortize an ESOP loan provided required amounts are first released and allocated from the Section 4980 reversion. It is too rigid to "lock-up" the employer stock from any other ESOP transaction that might benefit plan participants.

Using the word "amount", which connotes dollar value, may mean that carefully structured 1/8 releases combined with the sponsor's other plan contributions are unravelled as the employer securities appreciate to the detriment of other plan contributions, or decline to the detriment of the sponsor's ability to contribute. Also, section 4980(c)(3)(C)(ii)(I) indicates that the value for section 415 purposes is established at the time securities are first credited to the suspense account.

**ESOP Comment 3:**

Section 111A(j)(1) of H..R.2636, amending Section 1136 of TRA 86; Code section 401(a)(27).

Background: TRA 86 provides that a determination as to whether a plan is a profit-sharing plan is to be made without regard to the employer's profits. Section 111A(j)(1) requires that in order to qualify under code subsection 401(a), a plan sponsor must designate to the Secretary whether the plan is a money purchase pension plan or a profit sharing plan.

**Problem:** Because an ESOP is neither a profit-sharing plan nor money purchase pension plan, it would not be qualified under the proposed amendments. (The same could be said of a defined benefit plan, or a stock bonus plan.)

**Solution:** Either delete the provision of H.R. 2636; or amend it to include other plans; or amend it by striking the word "subsection" and substitute in lieu thereof "paragraph".

**ESOP Comment 4:**

Section 111B(h) amending Section 1173 and 1854(c) of TRA 86; Code section 133.

Background: TRA 86 clarified that a qualified 133 loan may not originate with any member of a controlled group, and clarified that a qualified securities acquisition loan may be refinaced and qualify for 133 treatment. H.R. 2636 provides further clarification as to how long 133 treatment applies to a refinanced loan.

Problem: It is unclear whether a securities transaction loan that is not eligible for 133 treatment (e.g. because it is within a controlled group, or originates with the employer) is eligible for section 133 treatment if refinanced in a manner qualifying for section 133 treatment. Furthermore, it is not clear as to the meaning, or impact, of current law section 133(b)(3)(B) pertaining to "more rapid repayment...of interest", because interest is paid; interest is never "repaid". In addition, the present wording may have the unintended effect of implying that interest payment is a repayment term for determining whether the terms of a lender-to-employer loan and an employer-to ESOP loan are "substantially similar".

Solution: Clarify that an otherwise in eligible securities acquisition loan is eligible for section 133 treatment if refinanced, and delete any reference to repaying interest.

Suggestion: Amend subparagraphs (C) and (D) of 1854(c) of TRA 86 (Code section 133(b)(2) and (3)(B)) would read as follows (added words underlined and deleted words stricken through):

"(2)...
For purposes of this paragraph, subparagraphs (A) and (B) shall not apply to any loan which, but for such subparagraphs, would be a securities acquisition loan if such loan was not originated by the employer of any employees who are covered by the plan or by any member of the controlled group of corporations which include such employer, except that this section shall not apply to any interest received on such loan during such time as such loan is held by such employer (or any member of such controlled group). This paragraph does not apply to a loan used to refinance a loan described in this paragraph unless such a loan is described in subparagraph (A) or (B).

(B) repayment terms providing for more rapid repayment of principal ~~or interest~~ on such loan but only if - "

Justification: The loan origination was not intended to preclude a refinancing which qualifies for the interest exclusion because such a loan benefits plan sponsor and participants with lower debt payments (provided the original loan is used to acquire employer securities after the effective date of section 133).

Note: As presently worded, Code section 133(b)(3), which limits the 133 treatment to 7 years if the qualified loan is refinanced, may not apply to the refinancing of a loan directly to an ESOP as opposed to a loan to the corporate sponsor of the ESOP. H.R.2636 clearly limits section 133 treatment to 7 years for refinanced, or a series of refinanced loans, whether the original loan was to the corporation or the ESOP. This problem came to the Association's attention subsequent to our formal review of TRA 86 and H.R.2636.

**ESOP Comment 5:**

Section 111B(g)(3)(B), amending Section 1172 of TRA 86; Code section 404(k).

Background: Section 111B(g)(3)(B) clarifies that a deduction is permitted for dividends paid on allocated ESOP stock used to pay ESOP debt if employer securities in equal to the dividends are released to participant accounts. Because the payment of dividends on ESOP stock, and their distribution to plan participants creates a variety of anomalies with requirements pertaining to distribution under 401, 409, and 4975, Congress added language to Code section 404(k) clarifying any distribution under 404(k) does not violate any 401, 409, and 4975(e)(7) requirements.

Problems: (1) The word "amount" may cause confusion if the value of employer securities appreciates or declines in relationship to the value of dividends used to pay debt.

(2) Paragraph (e)(7) of code section 4975 defines an employee stock ownership plan. By limiting the reference to paragraph (e)(7), the current 404(k) provision leaves open to interpretation whether a dividend distribution to ESOP participants or the use of the dividends to pay an ESOP loan might not comply with Code section 4975(d)(3), the ESOP exemption from the prohibited transaction rules. Also, by addressing only the distribution of dividends, section 404(k) fails to clarify that dividends used to pay ESOP debt (the dividends are thus not distributed) do not cause an ESOP to violate sections 401,409, 4975(d)(3) and (e)(7).

Solutions: (1) Delete the word "amount".

(2) Clarify that Code section 404(k) dividends do not violate the prohibited transaction provisions.

Suggestions: (1) The sentence at the end of Code section 404(k)(2)(C) would read as follows (deleted word stricken through):

"Paragraph (2)(C) shall not apply to dividends from employer securities which are allocated to any participant unless the plan provides that employer securities ~~in-an-amount~~ equal to such dividends are allocated to such participant for the year which (but for paragraph (2)(C)) such dividends would have been allocated to such participant."

(2) Add "and (d)(3)" to paragraph 1854(b)(3). The flush portion of code section 404(k) would then read as follows (added reference underlined):

"(k)...
Any deduction under subparagraph (A) or (B) of paragraph (2) shall be allowed in the taxable year of the corporation in which the dividend is paid or distributed to the participant under paragraph (2) or used to make payments on a loan described in section 404(a)(9). A plan to which this subsection applies shall not be treated as violating the requirements of section 401, 409, or 4975(d)(3) and (e)(7) merely by reason of any distribution described in paragraph (2). The Secretary may disallow the deduction under this subsection for any dividend if the Secretary determines that such dividend constitutes, in substance, an avoidance of taxation. Any deduction under paragraph (2)(C) shall be allowable in the taxable year of the corporation in which the dividend is used to repay the loan described in such paragraph."

Justification: (1) Clarifies that employer securities equal to value of dividends paid on debt are to be allocated to participants.

(2) Code section 4975 sets forth prohibited transactions and the tax thereon. Paragraph (e)(7) only defines what is an ESOP. The intent was to reference all the ESOP rules, not just 4975(e)(7)/ To eliminate any doubt whether an ESOP deductible dividend distributed to participants or used to pay an ESOP loan is a prohibited transaction, the reference also needs to include Code section 4975(d)(3).

NOTE: Proposed section 404(k)(2)(C) provides that in order to deduct dividends on allocated employer securities, when the dividends are used to pay an ESOP loan, a minimum allocation of employer securities must be made to plan participants. It is not clear whether this minimum allocation requirement may be satisfied with securities released from the suspense account (and allocated to participant accounts under section 54.4975-11 of the Income Tax Regulations) by reason of the use of dividends on allocated shares to repay the ESOP loan. Although this problem came to the ESOP Association's attention subsequent to the Advisory Committee's technical critique of TRA 86, the Association believes a clarification on this point would be helpful.

**ESOP Comment 6:**

Section 111B(i)(1), amending TRA 86 section 1174; Code section 409(d)(1)

Background: Section 111B(i)(1) cross references to 401(k)(10)(B)(ii) (which is added by H.R. 26360 to clarify the rules for distributions upon the termination of a plan or the disposition of assets, because the tax-credit for ESOP contribution was repealed and the 84-month rule is to be, in essence, waived.

Problem: The waiver of the 84-month rule references the requirement that a terminated plan must distribute in a lump sum as defined by section 402(e)(4) (as referenced by 401(k)(10((B)). This creates unintended results. For example, if an employer also maintains a stock bonus plan, employees' distributions from a terminated tax-credit ESOP would not qualify for lump-sum distribution treatment unless employees' stock bonus account balances are also distributed in the taxable year. Also, the REA pre-retirement consent requirement precludes a forced distribution, raising the possibility that an employee could not terminate a TRASOP/PASYSOP if a single employee objects to the distribution. This was not the intent of the amendment.

Solution: Add to paragraph 409(d)(1) a new exception to the 84-month rule that the rule does not apply in the event of the total discontinuance of plan contributions.

Suggestion: Add to paragraph 1174(a)(1) of TRA 86, the words "or complete discontinuace of contributions". Code section 409(d)(1) would read as follows (added words underlined and deleted words stricken through):

"(1) death, disability, separation from service, ~~or~~ termination of the plan~~,~~ , or complete discontinuance of contributions."

Justification: This addition would allow the employer to distribute account balances in a simple manner from a terminated or a dormant plan without having to make the employees wait up to 7 years. Congress has repealed TRASOP/PAYSOPs, and there is no reason to complicate their phase-out.

**ESOP Comment 7**

Section 111B(j) of H.R. 2636, amending section 1175 of TRA 86; Code section 401(a)(28).

Background: The House wanted to make ESOP assets more diversified as participants approach retirement age. This desire led the House to impose a requirement on ESOPs that allows a participant to diversify his or her account away from one asset, the employer's stock, as retirement age approaches. Because this new rule is a major change in how ESOPs operate, the House decided to apply the rule prospectively -- to stock acquired by the ESOP after December 31, 1986.

Problem: The contribution to an ESOP or PAYSOP usually occurs several months after the close of a plan year or tax year. For example, assume a PAYSOP sponsor has a calendar plan and tax year ending December 31, 1986. This PAYSOP sponsor will make its last tax-credit eligible contribution sometime in 1987. As written, Code section 401(a)(28) requires that this last PAYSOP contribution (and only this last one) be eligible for diversification. This diversification requirement for a relatively small amount of stock would create a needless administrative problem.

Solution: Exempt PAYSOPs from 401(a)(28).

Suggestion: Delete from paragraph 401(a)(28)(A) the words "or a plan which meets the requirements of section 409(a)." Code section 401(a)(28)(A) would then read as follows (deleted words stricken through):

"(A) In General. - In the case of a trust which is part of an employee stock ownership plan (within the meaning of section 4975(e)(7)) ~~or a plan which meets the requirements of section 409(a),~~ such trust shall not constitute a qualified trust under this section unless such plan meets the requirements of subparagraphs (B) and (C)."

Justification: Diversifying the last contribution to a PAYSOP will not serve Congressional intent in enacting the ESOP diversification rule because -

- there is no evidence that any sponsor of a PAYSOP ever had the PAYSOP as the only ERISA plan for employees;

- typically, employees' account balances are relatively small in relation to other benefits provided by the employer.

- generally, only a small percentage of the sponsor's shares outstanding are held by a PAYSOP; and

- the amount of value of the last year contribution is more than likely less than the cost per account if diversification is required.

**ESOP Comment 8**

Section 111B(j) of H.R. 2636, amending section 1175 of TRA 86, TRA 86 subsection 1175(a)(1); Code section 401(a)(28)(B).

Background: See Comment 7

Problem: As written, the ESOP diversification rule may require the diversification of ESOP assets invested in other than employer securities. (ESOPs are required to include a statement that they are designed to invest "primarily" in employer securities.) Very few ESOPs have assets consisting only of employer securities. The non-employer security assets of an ESOP may be cash equivalents, or any other of a variety of investments.

Solution: Clarify that the ESOP diversification rule applies only to the portion of a participant's account invested in employer securities acquired after 1986.

Suggestions: Add to clause 401(a)(28)(B)(i) the words "invested in employer securities", which clause would then read (added words underlined):

"(i) In General. - A plan meets the requirements of this subparagraph if each qualified participant in the plan may elect within 90 days after the close of each plan year in the qualified election period to direct the plan as to the investment of at least 25 percent of the participant's account in the plan invested in employer securities (to the extent such portion exceeds the amount to which a prior election under this subparagraph applies).

In the case of the election year in which the participant can make his last election, the preceding sentence shall be applied by substituting '50 percent' for '25 percent'."

Justification: The purpose of the ESOP diversification rule is to permit a participant to partially "get out" of employer stock. The rule should not require diversification of that which is already diversified. Because an ESOP must be designed to be primarily invested in employer stock, not diversifying the non-employer stock assets will not in any way weaken the purpose of the ESOP diversification rule. The Blue Book (on page 838) sanctions the plan sponsor using "alternative assets" in the plan to satisfy a diversification instruction. The clear thrust of the Blue Book position (and the legislative intent) is that the non-stock assets are not subject to diversification.

**ESOP Comment 9**

Section 111B(j) of H.R. 2636, amending Section 1175 of TRA 86; Code sections 401(a)(28)(B) and 402(e)(4).

Background: The House recognized that mandating an employer to maintain three investment options under the diversification rule might create a burden on some ESOP sponsors. Thus it authorized a distribution of the amount the participant elects to diversify.

Problem: If the participant receives a distribution pursuant to an ESOP diversification election after age 59-1/2, current law may deem that distribution to be the only lump sum distribution under the special tax rules for lump sum distributions.

Solution: Exclude a distribution pursuant to an ESOP diversification election from the definition of "lump sum distribution".

Suggestion: Add words "and does not include amounts distributed because of a distribution under 401(a)(28)(B)" to paragraph 402(e)(4). Code section 402(e)(4) would then read as follows, (added words underlined):

"(A) Lump sum distribution. - For purposes of this section and section 403, the term 'lump sum distribution' means the distribution or payment within one taxable year of the recipient of the balance to the credit of an employee which becomes payable to the recipient -

(i) on account of the employee's death,
(ii) after the employee attains age 59-1/2,
(iii) on account of the employee's separation from the service, or
(iv) after the employee has become disabled (within the meaning of section 72(m)(7)).

from a trust which forms a part of a plan described in section 401(a) and which is excempt from tax under section 501 or from a plan described in section 402(a). Clause (iii) of this subparagraph shall be applied only with respect to an individual who is an employee without regard to section 401(c)(1), and clause (iv) shall be applied only with respect to an employee within the meaning of section 401(c)(1). Except for purposes of subsection (a)(2) and section 402(a)(2), a distribution of an annuity contract from a trust or annuity plan referred to in the first sentence of this subparagraph shall be treated as a lump sum distribution. For purposes of this subparagraph, a distribution to two or more trusts shall be treated as a distribution to one recipient. For purposes of this subsection, subsection (a)(2) of this section, and subsection (a)(2) of section 403, the balance to the credit of the employee does not include the accumulated deductible employee contributions under the plan (within the meaning of section 72(o)(5)), ~~.~~ , and does not include amounts distributed because of a distribution under section 401(a)(28)(B)."

Justification: Because a 401(a)(28)(B) distribution does not authorize a full distribution of the account, there is no reason to treat the distribution as a lump sum distribution. The diversification requirement was not intended to disqualify employees' subsequent distributions for lump sum distribution treatment. Disallowing this exception would disadvantage employees.

**ESOP Comment 10**

Section 111B(j) of H.R. 2636, amending section 1175 of TRA 86; Code sections 401(a)(28)(B) and 402(a)(5)(D)(i).

Background: Because the House decided to allow the ESOP diversification election to be met by a distribution, the House also decided that such a distribution would be eligible for a tax-free rollover to an eligible retirement plan. It is also necessary to note that TRA '86 subparagraph 1175(a)(2) made the diversification rule apply only to stock acquired after December 31, 1986.

Problem: Many ESOP sponsors, in order to ease administrative burdens, will want to allow a participant to diversify both pre-1987 and post-1987 employer stock. In other words, they will want to go beyond the minimum legal requirements. Because clause (i) of 402(a)(5)(D) seems to allow a tax-free rollover only of the amounts required to be diversified, a more generous diversification amount may not be eligible for a tax-free rollover.

Solution: Substitute the word "permitted" for the word "described" in Code section 402(a)(5)(D)(i), which would then read as follows (added word underlined, deleted word stricken through).

> "(i) Requirements. - Subparagraph (a) shall apply to a partial distribution only if the employee elects to have subparagraph (A) apply to such distribution and such distribution would be a lump sum distribution if subsection (e)(4)(A) were applied -
>
> (I) by substituting '50 percent of the balance to the credit of an employee' for 'the balance to the credit of an employee',
> (II) without regard to clause (ii) thereof, the second sentence thereof, and subparagraph (B) of subsection (e)(4).
>
> Any distribution ~~described~~ permitted in section 401(a)(28)(B)(ii) shall be treated as meeting the requirements of this clause.

Justification: The Congressional purpose of encouraging ESOP participants to diversify their accounts is enhanced by greater diversification than is required by the diversification rule. This enhancement should not be thwarted by doubt as to whether amounts greater than the required amounts are eligible for a tax-free rollover. The Blue Book on page 836 states that a more generous diversification percentage than that required by section 401(a)(28)(B) is permissible.

**ESOP Comment 11**

Section 111B(k) of H.R. 2636, amending section 1176 of TRA 86; Code section 401(a)(22).

Background: Section 1176 of TRA 86 was a Senate floor amendment narrowly drawn to limit voting rights pass-through on ESOP stock of certain newspapers.

Comment: Section 111B(k), by amending the voting rights provision in Section 401(a)(22), may make a substantive change in the law pertaining to stock bonus plans of publicly traded corporations. There is no evidence to indicate Congress wanted to change the voting rights of stock bonus plans sponsored by publicly traded corporations.

**ESOP Comment 12**

Subsection 1174(b) of TRA 86 pertains to the period of time an ESOP participant's balance must be paid to him or her. Code section 409(o)(1)(C).

Background: The law requires that the distribution of the participant's account be over a period of not less than 5 years if the account value does not exceed $500,000, or 5 years plus 1 year for each $100,000 value, or fraction thereof, the balance exceeds $500,000. The House in adopting the 5 year payment period appears to have done so in recognition that sizeable ESOP accounts, when cashed out, may present a difficult repurchase liability, or demand on corporate cash flow, profits, and assets. If such a demand is unmanageable, the payments to a departing, or a few departing employees, can actually hurt the other ESOP participants who could have their account balances decline as the corporation is weakened by unmanageable repurchase liability.

Problem: It may be more advantageous both to the corporation and to the remaining employees to distribute the amount over a period of less than 5 years.

Solution: Clarify that the 5-year periodic payment requirement allows for more rapid distribution.

Suggestion: Add the phrase "no less rapidly than" to Code section 409(o)(1)(C). Code section 409(o)(1)(C) would therefore read as follows (added words underlined):

> "(C) Limited Distribution Period. - The plan provides that, unless the participant elects otherwise, the distribution of the participant's account balance will be no less rapidly than in substantially equal periodic payments (not less frequently than annually) over a period not longer than the greater of -"

Justification: There is no policy reason to require that the distribution period always be 5 or more years.

**ESOP Comment 13**

Subsection 1174(b) of TRA 86 permits the participant to elect distribution for a period longer than 5 years, or less frequently than once annually. Code section 409(o)(1)(C).

Background: In order to allow both the participant and the plan sponsor a degree of flexibility in making payments over a minimum period of time, the House agreed to allow the participant to elect distribution for a period greater than 5 years.

Problem: As written, subsection 1174(b) may have no limit on the participant's election - i.e., the limit is only his or her creativity.

Solution: Clarify that participant's election only allows choice of options permitted under the plan document.

Suggestion: Add the phrase "other options provided under the plan" to Code section 409(o)(1)(C). This subparagraph of the Code would read as follows (incorporating Comment 12, added words are underlined and deleted words are stricken through):

"(C) Limited Distribution Period. - The plan provides, unless the participant elects other options provided under the plan ~~otherwise~~, the distribution of the participant's account balance will be no less rapidly than in substantially equal periodic payments (not less frequently than annually) over a period not longer than the greater of -"

Justification: Allowing options other than those set forth in the plan document could be problematic if certain creative distribution schemes were permitted.

**ESOP Comment 14**

Subsection 1174(c) of TRA 86 pertains to the corporation's obligation to honor a put by an employee. Code section 409(h)(5)(A).

Background: In 1978, Congress mandated that an employee, who receives employer stock for which there is no public market, could sell his or her stock back to the ESOP corporate sponsor, and the ESOP sponsor must buy the stock at a fair market value price. This arrangement is the ESOP "put" requirement.

Problem: Code section 409(h)(5)(A) provides that the employer meets its put obligation if it pays for the employee's stock over a period not to exceed 5 years with periodic payments, not less frequently than annually. The literal wording of the subparagraph (A) may preclude the employer from making a lump-sum payment in complying with the put rule.

Solution: Clarify that the 5-year payment rule does not preclude a lump-sum payment.

Suggestion: Add to subparagraph (A) the words "not less rapidly than". Code section 409(h)(5)(A) would then read as follows (added words underlined):

"(A) the amount to be paid for the employer securities is paid not less rapidly than anually in substantially equal periodic payments (not less frequently than annually) over a period beginning not later than 30 days after the exercise of the put option described in paragraph (4) and not exceeding 5 years, and"

Justification: TRA '86 does not preclude lump-sum payments by ERISA plans. Thus the ESOP sponsor should be able to make lump-sum payments as permitted other ERISA plan sponsors. On page 841 of the Blue Book, a lump-sum distribution is implicitly sanctioned by reference to "total distribution" within a year.

**ESOP Comment 15**

Subsection 1174(c) of TRA 86 sets forth an adequate security rule for the ESOP sponsor to follow in meeting a put. Code section 409(h)(5)(B).

Background: If the ESOP sponsor honors a put over a multiple year period through periodic payments, its commitment is analogous to the employee having an IOU from its former employer. Congress recognized this debtor-creditor analogy and requires the ESOP sponsor to provide adequate security to the former employee in order to have a reasonable assurance that the ESOP sponsor's obligation will be honored.

Problem: The phrase "adequate security" is not precise, and if interpreted in an unreasonable manner, could result in all lenders to the ESOP being subordinated to the former employee exercising a put that is being paid out over several years. If the former employee has a higher call on corporate assets than other lenders to the corporation, the corporation, in all likelihood, will be impaired in its ability to obtain any kind of financing, either long-term, short-term, bonds, letters of credit, etc.

Solution: Clarify that "adequate security" does not mean a lien on the corporation higher than other corporate creditors.

Suggestion: Include in the Committee Report on H.R.2636 that the requirement for adequate security may be satisfied by a device such as a surety bond or letter of credit.

Justification: If the adequate security required causes the ESOP sponsor to impair (or possibly lose) its corporate credit, current ESOP participants will be harmed as surely the value of their stock would decline, perhaps drastically.

### ESOP Comment 16

Paragraph 1854(f)(1)(A) of TRA 86, pertaining to voting rights pass through in an ESOP or workers' co-operative (eligible worker-owned cooperative) (EWOC). Code section 409(e)(5).

Background: Because a worker owned co-op does not have percentage voting on governance issues based on corporate shares owned, Congress decided to sanction a 1 vote per participant method for ESOPs and EWOCs as an alternative to percentage, or proportional, voting.

Problem: As written, the new 1-man/1-vote rule may be construed by some to be mandatory.

Solution: Clarify that Congress intended the 1-man/1-vote rule to be an alternative to pass through of voting decisions.

Suggestion: Add the word "also" to paragraph 1854(f)(1(A). Code section 409(e)(5) would then read as follows (added word underlined):

> "(5) 1 vote per participant. - a plan also
> meets the requirements of paragraph (2) or
> (3) with respect to an issue if -
> (A) the plan permits each participant 1 vote with
> respect to such issue, and
> (B) the trustee votes the shares held by the
> plan in the proportion determined after application
> of subparagraph (A)."

Justification: As recognized in the Technical Corrections Blue Book, page 162, Congress never intended to mandate 1-man/1-vote for all ESOP corporate sponsors.

**ESOP Comment 17**

Subparagraph 1854(f)(3)(C) of TRA 86, pertaining to the distribution of employer securities. Code section 409(h)(2).

Background: Among the Congressionally mandated rules governing ESOPs is the rule requiring the ESOP to distribute employer stock, but also allowing a put by the participant of the stock if it is not readily tradeable. Congress has sanctioned that an ESOP sponsor, who wishes to become and/or remain substantially or totally owned by active employees, can require the participant to sell his or her stock back to the ESOP sponsor.

Problem: In clarifying this rule, subparagraph (C) may make it possible for the departed employee to keep the stock, undermining the very purpose of the provision.

Solution: Clarify that an ESOP company can restrict ownership of stock to current employees.

Suggestion: Change the word "may" to "must" in subparagraph 1854(f)(3)(C). Code section 409(h)(2) would then read as follows (added word underlined, deleted word stricken through):

> "(2) Plan may distribute cash in certain cases. - A plan which otherwise meets the requirements of this subsection or of section 4975(e)(7) shall not be considered to have failed to meet the requirements of section 401(a) merely because under the plan the benefits may be distributed in cash or in the form of employer securities. In the case of an employer whose charter or by-laws restrict the ownership of substantially all outstanding employer securities to employees or to a trust described in section 401(a), a plan which otherwise meets the requirements of this subsection or 4975(e)(7) shall not be considered to have failed to meet the requirements of this subsection or of section 401(a) merely because it does not permit a participant to exercise the right described in paragraph (1)(A) if such plan provides that participants entitled to a distribution from the plan shall have a right to receive such distribution in cash, except that such plan may distribute employer securities subject to a requirement that such securities may must be resold to the employer under the terms which meet the requirements of section 409(o)."

Justification: The word "may" contradicts the very reason the provision was enacted because it permits a non-employee to retain distributed employer securities, and thereby could result in an employer no longer being substantially (or totally) employee-owned. The current language allows employees to retain the stock. The purpose of the provision is to require them to sell it back to the corporation. Without the "must", Congressional intent would be undone.

**ESOP Comment 18**

Sections 1132 and 1175 of TRA 86; Code section 41 and 4980(c)(3).

Comment: An employer who transfers excess assets from a terminated defined benefit plan should not be allowed to use those employer securities in order to fund a tax credit ESOP (i.e., when claimed on a carryforward basis).

**ESOP Comment 19**

Section 111A(g) of H.R. 2636, relating to section 1133 of TRA 86; Code section 4981A (to be redesignated 4980A by H.R. 2636).

Background: Code section 4981A(c)(5) "grandfathers" from the excess distribution tax certain amounts distributed from a plan or plans if (1) an election is made under paragraph (5), and (2) if the accrued benefits as of August 1, 1986, exceed $562,500.

Problem: The "grandfather" is not a true "grandfather" in that it does not exempt individuals from paying the tax, but exempts from the tax only the amount in their account as of August 1, 1986. Thus, in the case of employer securities that appreciate past August 1, 1986, there may be an excess excise tax on that value.

Comment: Although not a technical comment, the ESOP Association takes this opportunity to express once again its strong opposition to the excess excise tax on certain distributions. The Association strongly believes that employee-ownership is to lead to employee-owners getting more than "just a little money". ESOPs are to break the concentration of wealth through widespread ownership of capital. An absolute cap, or a tax on ownership wealth by employees is contrary to the Association's overall position.

We also realize that the TRA 86 "grandather" is for "accrued" benefits as of August 1, 1986, not for individuals and their employer securities as of August 1, 1986. Thus we realize that a suggestion to amend section 4980A(c)(5) to "grandfather" plan accounts, not accrued benefits, would be a substantive change. We do feel such a change, however, would be more equitable than current law.

**ESOP Comment 20**

Section 111B(h) of H.R. 2636 amending section 1173 of TRA 86; Code sections 133, 851(h) and 852(b)(5)(C).

Note: Subsequent to the technical review of TRA 86 by the Association Advisory Committee, it was noted that certain technical problems may exist that would prevent a mutual fund from holding securities acquisition loans and paying out tax-exempt dividends to one class and taxable dividends to another class of stock. Because section 133 provides that a precise $.50 of every interest dollar is exempt while $.50 is taxable, and because in real economic terms these two income streams are not equal, the mutual fund may desire to price its two classes of shares differently at inception. But serious issues arise under the Investment Company Act of 1940 if redemption prices of the two classes of shares are varied during the life of the fund.

Also, as the relationship between the taxable and the tax-exempt yield curve varies over the term of the loan (as it almost certainly will), it may be impossible to reset properly the interest rates on the two components of the loan (i.e., due to the 50/50 split, either too much tax-exempt or too much taxable interest will be paid).

To solve these problems, the mutual fund may frequently reset the interest rates on the securities acquisition loans. But it may not be possible, under current law, to reset interest rates by the mutual fund because the one-half and one-half requirement under section 133 may not allow a downward adjustment.

A solution may be to allow 50% of the principal of a securities acquisition loan held by a mutual fund with a two-class arrangement to be treated as an obligation described in section 103(a), and the interest attributable to that principal amount would be excludible from income, (thus permitting the interest rates for the two "halves" of a securities acquisition loan to be set separately at existing market rates). This concept already appears in section 852(b)(5)(C)). The revenue impact of such a "fix" should be positive because it should result in the least possible amount of exempt interest being paid.

Finally, section 851(h) treats each fund of a series fund as a separate mutual fund. It may be helpful to clarify that, in the case of securities acquisition loans held by a two-class mutual fund that constitutes a series fund, one fund could be deemed to own the tax-exempt principal portion and one fund the taxable principal portion.

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## Statement Submitted to Committee on Ways and Means U.S. House of Representatives in Connection with H.R. 2636, The Technical Corrections Act of 1987

### Introduction

This statement is being submitted in connections with the introduction of H.R. 2636, the Technical Corrections Act of 1987, and in conformity with requirements for such a submission as indicated at the bottom of page 1 of Press Release #12 Committee on Ways and Means dated June 10, 1987 and the formatting requirements set forth on page 2 of said release.

The authors of this submission are Norman C. Bensley and Betsy Finn Yegelwel, attorneys with the law firm of Finley, Kumble, Wagner, Heine, Underberg, Manley, Myerson & Casey. The law firm represents more than 20 domestic life insurance companies in many aspects of their operations, including, as is pertinent to this submission, development, registration, and compliance work in connection with variable life insurance and annuity products sold to individuals and certain types of employee benefit plans.

Variable annuities are being sold not only to individuals but to certain types of employee benefit plans, including section 403(b) plans, section 401(k) plans, and plans of deferred compensation provided by state and local governments and tax exempt organizations. As a result of uncertainty created by the Tax Reform Act of 1986, the tax impact of several aspects of the operation of these programs is as yet unclear.

### Section 72(u)

Specifically, we believe that in the case of annuities sold to section 457 deferred compensation plans of State and Local governments and tax exempt organizations, the provisions under section 72(u) and section 72(s) should not apply.

Section 72(u) added to the Code by the Tax Reform Act of 1986, provides for the taxation of income currently on annuity contracts owned by persons who are not natural persons. There are a number of exceptions to the application of this section, including the situation in which the annuity contract is held under a plan described in section 401(a) or 403(a) or under a program described in section 403(b), or under an individual retirement plan. Section 72(u)(3)(B).

For consistency, clarity, and certainty, a similar exception is needed for contracts held under plans described in section 457. It has been suggested that such an exception is not necessary because no tax is levied on state and local governments or tax exempt organizations, which are the subject of section 457. Yet no tax is levied on tax qualified plans, and an exception is specifically provided for them from section 72(u).

We urge that Congress add a section 457 exception to the application of Section 72(u). Section 72(s).

Section 72(s) was added to the Code by the Deficit Reduction Act of 1984 and modified by the Tax Reform Act of 1986, including the Technical Corrections provisions to the 1984 Act that were contained in the 1986 Act. This section provides for certain mandatory distributions of amounts held under annuity policies on the death of the contract holder in circumstances occurring both before and after beginning of the annuity distribution.

Where annuity contracts are held by state and local governments or tax exempt entities under deferred compensation plans governed by section 457, multiple, and possibly conflicting, distribution requirements may come into play. In the case of such plans, the plan participant would presumably also be the "primary annuitant" under the annuity contract. Section 72(s)(6). On the death of that individual, section 72(s) distribution rules would be triggered (the death of the primary annuitant being the triggering event under section 72(s)(6)) at the same time that the distribution requirements would be triggered under section 457(d) (for tax years beginning after 1988).

As an example of possible conflicting provisions, note that under section 72(s)(1)(B) the general rule is that distribution must occur within five years after death where death itself occurs before the annuity starting date. In contrast, under section 457(d)(2)(B)(ii) (for tax years beginning after 1988), death before commencement of distribution triggers a distribution period not to exceed fifteen years.

The inconsistency could be resolved by a provision exempting annuity contracts held under section 457 plans from the section 72(s) rules. As under other qualified plans, which are specifically excepted from section 72(s), the exception of section 457 plans would provide for simplified administration. The exception would also be consistent with the purpose of section 72(s) of not prolonging the annuity buildup period significantly beyond the life of the original annuitant, since section 457 plans as well as other tax qualified plans are subject to their own specific distribution requirements upon the participant's death.

## Section 818

Finally, we note that section 818(a)(6) includes in the definition of pension plan contract "an eligible State deferred compensation plan" under section 457(b). We believe that the cross reference to section 457(b) should be modified to eliminate the word "State" since, beginning in 1987, section 457 is also applicable to tax exempt organizations.

In discussions earlier in the year with Ways and Means staff, we were told that these changes did appear to be technical rather than substantive or policy in nature. We subsequently understood that they would not be included in the original draft of Technical Corrections, not because a contrary judgment had been made, but because they appeared to be unnecessary. We submit, for the reasons stated above, that these corrections will be extremely useful in aiding statutory interpretation, are strictly technical in nature and entirely consistent with existing statutory intention, and since they will not change the current understanding of the rules involved, will have no revenue impact.

Finally, since variable annuity policies are subject to disclosure requirements under Federal and State securities laws, the public interest will be served by the ability to offer the most unequivocable language in registration statements and other disclosure material.

Thank you for your consideration of these matters.

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July 17, 1987

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Re: Technical Corrections Bill of 1987 (H.R. 2636)

Dear Mr. Leonard:

Enclosed is a comment pertaining to the application of the $200,000 limit on the compensation that may be taken into account under a qualified plan to a highly compensated employee where a member of his family works for the same employer.

Very truly yours,

David S Foster

David S. Foster

## DEFINITION OF HIGHLY COMPENSATED EMPLOYEE

## $200,000 LIMIT

### Description of Provision

Section 1114(a) of the Tax Reform Act of 1986 added Section 414(q) to the Code, defining the term "highly compensated employee." Section 414(q)(6) provides that if an individual is a member of the family of a 5-percent owner or of a highly compensated employee in the group consisting of the 10 highly compensated employees paid the greatest compensation during the year, then such individual shall not be considered a separate employee, and any compensation paid to such individual shall be treated as if it were paid to the 5 percent owner or highly compensated employee. The provision did not state for what purpose the rule applies.

Section 111(j)(2) of the Technical Corrections Bill of 1987 would amend Section 414(q)(6) by adding a new subparagraph (C), clause (i) of which would provide:

> "Except as provided in regulations and in clause (ii), the rules of subparagraph (A) shall be applied in determining the compensation of (or any contributions or benefits on behalf of) any employee for purposes of any section with respect to which a highly compensated employee is defined by reference to this subsection."

Section 111 (d)(4) of the Technical Corrections Bill would amend Section 401(a)(17) by adding at the end thereof the following new sentence:

> In determining the compensation of an employee, the rules of section 414(q)(6) shall apply, except that in applying such rules, the term 'family' shall include only the spouse of the employee and any children of the employee who have not attained age 19 before the close of the year."

## Problem

The proposed provisions create two different types of penalties, a tax penalty and an economic penalty:

1. Tax Penalty. Treating married persons who work for the same employer as one person for purposes of the $200,000 limit is a significant marriage penalty which is not justifiable on tax policy grounds.

Presumably, the fear is that, in the absense of these provisions, one spouse whose true compensation is over $200,000 will divert a portion of his true compensation to his spouse or minor child in order to avoid the $200,000 limit. This is a valid concern. However the means chosen to deal with the concern is inappropriate.

There are in fact situations where the members of a family unit are each paid their true compensation, even though they work for the same employer, and even though their aggregate compensation exceeds $200,000. The effect of the proposal would be to discourage marriage by coworkers and to discourage spouses from working for the same employer.

There are other ways of assuring that the compensation of one family member is not diverted to another. And even if no other way was available, the proposed solution would still be worse than the abuse. For every small businessman who puts his wife and children on the payroll without asking them to perform any duties, there are hundreds of bona fide situations where executives of a large corporation decide to marry each other.

2. Economic Penalty. Married persons who work for the same employer (who maintains a qualified plan) and jointly make over $200,000 will automatically have their compensation reduced. Their employer will make smaller contributions to defined contribution plans and pay smaller benefits out of defined benefit plans.

Every employer who maintains a qualified plan should respond by adopting a supplemental nonqualified plan to counteract the discrimination. This places a tremendous burden on the United States economy, far outweighing the magnitude of the problem. Moreover, in many cases the nonqualified plan would have to be funded, resulting in substantial additional costs on employers in order to make their married employees come out even.

Since the burden is so much greater than the problem, one can anticipate that employers will not adopt the supplemental nonqualified plans, and the burden will be on the employees either not to marry, or to work for different employers. The only alternative is to work for less aggregate compensation.

## Proposed Solution

Each person should be treated separately for purposes of the $200,000 limit.

## STATEMENT FOR THE RECORD ON BEHALF OF THE NATIONAL CONFERENCE OF STATE LEGISLATURES

Mr. Chairman, on behalf of the National Conference of State Legislatures, thank you for this opportunity to submit a statement for the record regarding pension issues for the Technical Corrections Act of 1987 (H.R.2636 and S.1350) to the Tax Reform Act of 1986 (TRA), P.L.99-514.

The most comprehensive tax overhaul in this country's history has left state government with the onerous task of analyzing tax reform's impact on state and local public pension systems and employees. Congressional revision of the tax treatment of retirement savings is estimated to offset the reduction in personal income tax rates by $44 billion for the five year period from 1987 to 1991.

The broad scope of tax reform produced unintended consequences for public employee retirement systems and employees of state and local governments. Specifically, the National Conference of State Legislatures (NCSL) has identified as grave concerns:

- o the mandate of distribution of pension benefits at age 70 and a half (Section 1122) which preempts state retirement policy and potentially jeopardizes the fiscal integrity of state retirement systems;
- o the repeal of the three year recovery rule (Section 1121) which penalizes public employees who make after-tax contributions to retirement; and
- o the U.S. Department of Treasury interpretation of the modifications to Section 457 (Section 1107) which jeopardizes the deferred tax status of elective contributions to retirement by broadening the definition of an elective contribution to include factors outside of the employee's ability to control.

### Exempt State and Local Governments From Mandatory Distribution of Pension Benefits At Age 70 and a Half:

NCSL urges Congress to exempt state and local governments from TRA's mandatory distribution of pension benefits at age 70 and a half. With that and the passage of the Age Discrimination in Employment Act of 1986, which eliminated forced retirement at age 70, a situation was created where an employee could simultaneously receive full salary, draw retirement benefits and accrue additional retirement credits. The conflict between the two laws preempted many state retirement policies which define, by statute, that retirement is a prerequisite for commencement of pension benefits.

Because Americans are living longer, healthier lives and many are working out of economic necessity, more employees are choosing to continue working long after "normal" retirement age. TRA's mandate will, therefore, significantly increase state pension funding requirements and the amount of time needed to finance pension benefits.

Retirement systems must immediately begin planning for the 70 and a half mandate of increased pension benefits for the 20 to 40 year olds currently in our work force. The 20 to 40 year olds, or the baby boomers, constitute a third of the nation's population. In 20 years, all retirement systems will feel the burden of an estimated 10 million baby boomers reaching retirement age. By the year 2030, it is estimated all of the baby boomers will have reached retirement age.

The 70 and a half mandate will put a financial burden on state and local public retirement systems at a time when many systems will be unable to shoulder this unwarranted additional fiscal responsibility. To date, twenty-four states have reported budget reductions and at least 11 states have enacted tax increases in order to meet constitutional mandates of a balanced budget.

TRA's mandate will, for example, add an $87.4 million pension liability to the budget of the State of Texas. Texas is currently trying to balance its budget while providing existing, essential services with dwindling revenues. The mandate will also increase the length of time necessary to meet anticipated pension obligations by 4.1 years for the Texas Employees' Retirement System.

Although my state of Massachusetts is one of the few states still enjoying a modest revenue surplus, we are beset by an unfunded pension liability totaling over $11 billion, a debt that will only worsen with this new federal requirement.

Because most states base retirement benefits on years of service and final salary computations, distribution of pension benefits at age 70 and a half will increase the complexity of record keeping and computation requirements of employee benefits for state systems by requiring continual adjustment of pension benefits and accruals with any fluctuation in salaries.

If the 70 and a half mandate is not met, public employees will be put in the precarious position of potentially losing half of their monthly retirement check. This would be, in effect, a 50 percent federal excise tax. This excise tax poses a substantial reduction for public employees who are dependent upon their retirement income to make ends meet.

The rule of mandatory distribution at age 70 was enacted in order to preclude highly paid private sector individuals from using retirement savings plans as vehicles to shelter income in estate planning. Few public employees are considered highly compensated. In Massachusetts, a state employee earns a moderate, average yearly income of $25,200. Because most state employees are dependent upon their pensions to provide income during retirement, they usually do not have the luxury of delaying the start of their pensions. The tax sheltering mechanism used by highly compensated private sector employees is simply unavailable to most public workers. NCSL believes that the financial security of state employees and retirement systems should not be jeopardized by a scatter-gun approach to a private sector problem.

**Mitigate Negative Effects of Repeal of the Three Year Recovery Rule on State and Local Employees:**

We urge Congress to mitigate the negative effects of the repeal of the three year recovery rule on the employees and retirement systems of state and local governments. Because most state pension plans require after-tax contributions of their employees, the repeal of the three year recovery rule has had a substantial impact on the public sector.

Unlike other retirement plans, employees participating in these state and local pension plans are unable to defer or deduct their contributions to retirement savings from federal income tax. Instead, their contributions must be made on an after-tax basis. To reconcile this disparity in tax treatment, the federal government had permitted public employees to accelerate the recovery of their previously taxed contributions in the first three years of receipt of pension benefits.

With the enactment of TRA, the three year recovery rule was retroactively repealed for all employees retiring after July 1, 1986. The new basis recovery rule, which requires public employee after-tax contributions to be proportionately recovered over the life of the annuity, does not recognize the disparity between tax treatment of public employee pension contributions and that of other retirement savings contributions.

The retroactive nature of the repeal is grossly unfair to state and local employees who retired after July 1, 1986, but before January 1, 1988. In essence, those individuals suffer a double penalty of the loss of the three year recovery rule under the new tax law and taxation at the higher, pre-TRA tax rates.

Secondly, the unexpected repeal of the three year recovery rule did not allow public employees adequate time to plan for the change in the tax treatment of their pension benefits. Because of the suddenness of the repeal, the financial security of many retiring state and local employees was impaired.

The new basis recovery rule and U.S. Department of Treasury regulations are inflexible and do not adequately address the variety of benefit options and types of benefits that determine the amount of an employee's pension benefits. For Massachusetts' state retirement system and the 101 local pension systems, Treasury's regulations do not consider the complicated nature and combination of types of benefits and various benefit options that state or local systems may offer.

We urge you to mitigate the negative effects of the repeal of the three year recovery rule and the onerous administrative requirements of the new basis recovery rule on state and local employees and retirement systems.

**Ensure that Deferrals to State and Local 457 Plans Are Non-Elective:**

NCSL calls upon Congress to clarify the law to ensure that employee contributions to non-elective unfunded deferred compensation plans of state and local governments and tax-exempt organizations under Section 457 are not subject to taxation until the benefit is actually distributed to the employee.

The U.S. Department of Treasury announced its intent to broaden the definition of an elective deferral to include deferrals based on factors outside of the employees' control in Internal Revenue Bulletin No. 1987-4. With this broader interpretation, the Department of Treasury has clearly violated the legislative history and intent of Congress. By definition, a non-elective deferral is one over which the employee has no control, such as that set by an employer based on such factors as salary or years of service.

For state and local employees, this means vacation leave, sick leave, survivor benefits, and even severance pay could now be considered in the $7,500 yearly limit on contributions to 457 retirement plans. These non-elective benefits would inflate and accelerate an employee's contribution to retirement and potentially cause an employee to violate the yearly $7,500 limit on retirement contributions. Any contributions over the $7,500 limit would be penalized with a 10 percent excise tax.

In addition, Treasury's proposed retroactive treatment of what it considers to be deferred contributions could potentially result in the retroactive taxation of an employee's contributions to retirement, and the taxation of other employee benefits which the employee may never have the benefit of actually receiving.

**Conclusion**

In 1986, the Congress rewrote the nation's tax laws to provide a more equitable and simple form of taxation. However, for the employees and retirement systems of state and local governments, tax simplification was not simple.

In ~~many cases~~, the consequences of tax reform pose serious threats to the fiscal integrity of state pension systems and the retirement plans of millions of state and local workers. The nation's 50 state legislatures are struggling to address these problems. We ask that you recognize the distinct character of state and local governmental employment and permit state and local governments the flexibility to effectively manage their work force by correcting the problems caused by the Tax Reform Act.

**REPRESENTATIVE KEVIN P. BLANCHETTE**

**Chair, Joint Public Service Committee**

**Commonwealth of Massachusetts**

**Chair, NCSL Pensions Subcommittee**

**National Coordinating Committee for Multiemployer Plans**

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July 10, 1987

## COMMENTS OF THE NATIONAL COORDINATING COMMITTEE FOR MULTIEMPLOYER PLANS ON TECHNICAL CORRECTIONS NECESSARY TO CLARIFY THE APPLICATION OF THE TAX REFORM ACT OF 1986 TO MULTIEMPLOYER PLANS

Robert A. Georgine, Chairman of the National Coordinating Committee for Multiemployer Plans[1] is pleased to provide these comments on technical corrections that are necessary to clarify the application of the Tax Reform Act of 1986 ("TRA"), to multiemployer plans.

### 1. Vesting.

Internal Revenue Code ("Code") section 411, as added by the TRA generally requires five-year cliff or seven-year graded vesting for qualified retirement plans. There is a multiemployer plan exception permitting ten-year cliff vesting with respect to participants covered by a collective bargaining agreement. However, the statute requires five-year cliff or seven-year graded vesting to be provided for participants who are not covered by a bargaining agreement.

Multiemployer plans often cover employees of the fund and of the related union and sometimes of the association of contributing employers. Clerical employees of the union are often, but not always, covered by collective bargaining agreements. However, fund and association employees and union officers often are not. In addition, some multiemployer plans permit employers who cover their union employees under the plan incidentally to cover salaried or other nonunion employees as well. The new law could be interpreted to require all such nonunion employees to be given five-year cliff or seven-year graded vesting.

Providing this faster vesting to these employees would create serious political problems for the plans. Rank-and-file union employees would feel that it is unfair for plans to provide five-year cliff or seven-year graded vesting to union officers and nonunion participants while providing only ten-year cliff vesting to the rank-and-file union members. The result would be to make the multiemployer plan exemption unavailable as a practical matter.

There is no evidence that Congress, in enacting the TRA, intended to interfere with the longstanding practice of multiemployer plans of covering union, fund, employer association and sometimes, incidentally, other employees on the same basis as employees covered by a collective bargaining agreement. On the contrary, it is most reasonable to treat union, fund, and employee association employees as though they were covered by a collective bargaining agreement, because they are an integral and necessary part of the process of bargaining for retirement benefits.

In addition, the multiemployer plan participants that would benefit from the five-year cliff or seven-year graded vesting rule are exactly the opposite of the type of participants that the rule is intended to protect. Thus, it is not unusual for some union officers and nonunion employees covered by these plans to be more highly paid than the rank-and-file employees covered by collective bargaining agreements.

These problems could be avoided by clarifying that, for this purpose, the term "collective bargaining agreement" includes a participation agreement covering nonunion employees incidental to the plan's coverage of employees covered by a collective bargaining agreement. A participation agreement should be deemed to provide such incidental coverage if: (1) it is entered into by the fund or related union or association of contributing employers on behalf of its employees; or is entered on behalf of nonunion employees by an employer who contributes to the plan for its union employees; and (2) coverage provided under the participation agreement does not reduce the percentage of plan participants who are covered by collective bargaining agreements below 85 percent.

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[1] The NCCMP is a nonprofit, tax-exempt organization established after Congress enacted ERISA in 1974. It consists of representatives of more than 180 pension and welfare plans, or their sponsors, and represents the interests of approximately nine million persons. On behalf of its affiliated plans, and the approximately nine million participants and beneficiaries of multiemployer plans generally, the NCCMP is entirely engaged in monitoring the development -- legislative, administrative, and judicial -- of the laws relating to the structuring and administration of multiemployer pension and welfare plans.

This clarification would make it administratively feasible for multiemployer plans to continue to provide ten-year vesting and would not provide any potential for abuse. Accordingly, we urge you to include the following provisions in the technical corrections to the TRA:

Paragraph (2) of section 411(a) of the Internal Revenue Code is amended by adding at the end thereof a new subparagraph (D) as follows:

> "(D) COLLECTIVE BARGAINING AGREEMENT. -- For purposes of subparagraph (C), the term 'collective bargaining agreement' includes a participation agreement which provides coverage to nonunion employees which is incidental to coverage provided to employees covered by a collective bargaining agreement. Such coverage will be considered incidental if the participation agreement --
>
> > (i) is entered into by the fund (or by any other collectively bargained employee benefit fund covering some or all of the same participants) or related union or association of contributing employers on behalf of its employees or is entered into on behalf of nonunion employees by an employer who also contributes to the plan on behalf of employees covered by a collective bargaining agreement, and
> >
> > (ii) coverage of such nonunion employees does not reduce the percentage of the plan's participants who are covered by collective bargaining agreements below 85 percent.

The 85 percent test described in clause (ii) will be satisfied if at least 85 percent (determined on a plan-wide basis) of the employees who are covered (or whose beneficiaries are covered) under the plan first became eligible for coverage under the plan on account of their being or having been covered by a collective bargaining agreement."

Paragraph (2) of Section 203(a) of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1053(a)(2)) is amended by adding at the end thereof a new subparagraph (D) as follows:

> "(D) For purposes of Subparagraph (C), the term "collective bargaining agreement" includes a participation agreement which provides coverage to nonunion employees which is incidental to coverage provided to employees covered by a collective bargaining agreement. Such coverage will be considered incidental if the participation agreement --
>
> > (i) is entered into by the fund (or by any other collectively bargained employee benefit fund covering some or all of the same participants) or related union or association of contributing employers on behalf of its employees or is entered into on behalf of nonunion employees by an employer who also contributes to the plan on behalf of employees covered by a collective bargaining agreement, and
> >
> > (ii) coverage of such nonunion employees does not reduce the percentage of the plan's participants who are covered by collective bargaining agreements below 85 percent.

The 85 percent test described in clause (ii) will be satisfied if at least 85 percent (determined on a plan-wide basis) of the employees who are covered (or whose beneficiaries are covered) under the plan first became eligible for coverage under the plan on account of their being or having been covered by a collective bargaining agreement."

2. Welfare Plan Reserve Limits.

The Deficit Reduction Act of 1984 ("DEFRA") imposed new reserve limits on welfare funds. Medical, life insurance, disability, SUB, and severance pay plans are permitted to have limited reserves not in excess of specified "account limits." Other plans are not permitted to have any reserves at all.

Employer contributions are not fully deductible if these limits are exceeded. Further, they may not be fully deductible in certain other circumstances, e.g., where the fund uses the contributions to purchase a "facility" with a useful life of more than a year. Also, under Code section 512(a)(3)(E), plan income will be subject to unrelated business taxable income ("UBTI") tax to the extent it increases reserves above permissible levels and to the extent of post-retirement medical benefit reserves.

Recognizing the unique characteristics and needs of collectively bargained plans, Congress provided in DEFRA for Treasury to promulgate, by July 1, 1985, special higher reserve limits applicable to such plans. However, Treasury was unable to devise workable limits. It therefore issued regulations deferring the effective date of the new rules with respect to such plans until final regulations with respect to such limits could be issued. Those regulations explicitly state that neither contributions to nor reserves of such plans shall be treated as exceeding the otherwise applicable limits of Code sections 419(b), 419A(b) (relating to deductibility limits), or 512(a)(3)(E) (relating to UBTI tax). This, in effect, provided a complete exemption for collectively bargained plans for an indefinite period.

Congress recognized, however, that this was not a satisfactory long-term solution to this problem. Plans, in designing their contribution and funding programs, need more certainty with respect to applicable rules. Accordingly, it amended Code section 419A(f)(5) to provide an exception from the reserve limits for collectively bargained plans as follows:

> "(5) Special Rule for Collective [sic] Bargained . . . Plans. -- No accounts [sic] limits shall apply in the case of any qualified asset account under a separate welfare benefit fund --
>
> (A) Under a collective bargaining agreement, . . ."

The clear intent of this provision, reflected in the Finance Committee's report on its bill, which contained almost identical language, was that "employer contributions to such VEBAs are deductible and earnings on assets of such VEBAs are tax-exempt." S. Rep. No. 313, 99th Cong. 2d Sess. 1010 (1986). Any more narrow interpretation would cut back on the preexisting regulatory exception -- a result which was clearly not intended by Congress. Further, the special nature and characteristics of collectively bargained plans makes a complete exemption necessary and appropriate. In particular, the nature of such plans, and of the collective bargaining process, generally precludes the abuses of principal concern. Also, the practical requirements of multiemployer plans, e.g., the need to set contributions at some fixed rate (based on hours of work or units of production) and the plans' basic economics,[2] mandate special reserve principles.

However, the statutory language cited above could be construed to fail to accomplish the intended result fully for the following reasons:

> (i) The language "no account limits shall apply in the case of any qualified asset account" could be construed to limit the exception to benefits for which qualified asset accounts may be maintained under section 419A(a), i.e., disability, medical, SUB or severance pay, and life insurance benefits. Thus, no relief would be provided for other funds, such as group legal or educational assistance.
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> (ii) The statutory language could be construed simply to increase permissible reserve limits. This would not correct certain anomalies such as the inability of employers contributing to collectively bargained plans to deduct fully contributions used by

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[2] Employer contributions to multiemployer plans generally do not rise to meet plan needs in the absence of a negotiated change to a collective bargaining agreement. Instead, because they are generally linked to levels of covered work, they tend to fall in times of aggravated participant need, e.g., recession, layoff, or industry decline.

the fund to purchase facilities with a useful life of more than one year. This would create special problems for multiemployer plans which, because they are separate and distinct entities from the contributing employers, must maintain their own separate facilities.

(iii) In addition, it could be argued that the statutory language does not address the imposition of UBTI tax on post-retirement medical benefit reserves under Code section 512 -- despite the fact that, as a policy matter, the imposition of this tax on reserves of funds permitted to maintain unlimited medical benefit reserves for active participants is clearly nonsensical.

Accordingly, to clarify the intended result of the statutory exception, we suggest that the following provisions be included in the technical corrections to the TRA:

Paragraph (5) of section 419A(f) is amended to read as follows:

"(5) Treatment of Collectively Bargained Funds --

"(A) In General. -- Neither contributions to nor reserves of a collectively bargained welfare benefit fund shall be treated as exceeding the otherwise applicable limits of section 419(b) or subsection (b) of this section.

"(B) Collectively Bargained Welfare Benefit Fund -- For purposes of subparagraph (A), the term 'collectively bargained welfare benefit fund' means a fund --

"(i) which is maintained pursuant to one or more collective bargaining agreements between employee representatives and one or more employers,

"(ii) with respect to which there is evidence of good faith bargaining over the benefits provided through the fund, or the funding for those benefits, and

"(iii) which satisfies paragraph (C) below.

"(C) A welfare benefit fund satisfies this paragraph if --

"(i) At least 85 percent of the employees who are eligible (or whose beneficiaries are eligible) to receive benefits under the fund first became eligible for coverage under the plan on account of their being or having been covered by a collective bargaining agreement.

"(ii) For purposes of (i) above, employees of the fund (or of any other collectively bargained employee benefit fund covering some or all of the same participants), sponsoring union or an association of contributing employers shall be deemed to be covered by a collective bargaining agreement."

Clause (i) of section 512(a)(3)(E) is amended by inserting after the words "In the case of an organization described in paragraph (9), (17) or (20) of section 501(c)" the words "(except for a collectively bargained welfare benefit fund, as defined in section 419A(f)(5)(B))."

### 3. Nondiscrimination Rules

#### a. Retirement Plans

Under the TRA, three alternative coverage tests apply to qualified retirement plans. All of these involve computing a percentage based on information about "highly compensated employees." They are as follows:

(i) 70 percent of all nonhighly compensated employees must be covered by the plan;

(ii) The percentage of nonhighly compensated employees covered by the plan must be at least 70 percent of the percentage of highly compensated employees covered; or

(iii) The group of employees covered by the plan must satisfy the present law nondiscriminatory classification test and the average benefit provided to nonhighly compensated employees (whether or not included in the plan), as a percentage of compensation, must be at least 70 percent of the average benefit provided to highly compensated employees (whether or not included in the plan), as a percentage of compensation.

In general, for this purpose, "highly compensated employees" include: (1) five percent owners; (2) employees earning over $75,000 per year; (3) employees earning over $50,000 per year who are in the top twenty percent of the employer's employees by compensation; and (4) officers earning over $45,000 per year (indexed for inflation).[3] However, if no officer satisfies this compensation requirement, the highest-paid officer will be treated as a highly compensated employee.

Multiemployer plans would, as a substantive matter, have no problem in satisfying these tests, but would, as a practical matter, rarely be able to demonstrate their compliance. The vast majority of participants of such plans are union-represented, rank-and-file employees who are not officers, owners, or highly paid. Further, multiemployer plans typically provide flat dollar benefits based only on years of service and unrelated to compensation. As a percentage of compensation, benefits under such plans are therefore disproportionate in favor of nonhighly compensated employees. Thus, such plans are not discriminatory.

However, it would be virtually impossible for these plans to prove that they satisfy any of the above percentage tests. This is because they typically do not have the information about the ownership, management, and compensation structure of contributing employers necessary to identify highly-compensated employees. Nor would contributing employers ordinarily be willing to provide this data to plan trustees, fifty percent of whom are required by law to be union representatives, and the other fifty percent of whom are generally highly-placed in the management structure of their competitors. Thus, permitting plan trustees access to data necessary to determine their plan participants' rank on employers' pay scales, or expanding employer recordkeeping and reporting requirements to the extent necessary to maintain up-to-date records on aggregate employee compensation would create significant problems in collective bargaining.

Indeed, many multiemployer plan participants work for several contributing employers during a year. Plans would be unable to determine, with respect to such employees, which employer's employees would serve as the group with respect to which the twenty percent test must be satisfied.

Also, total annual compensation of employees covered by multiemployer plans typically depends heavily on the number of hours the individual works during the year, including overtime, holiday, and other premium pay, and the hourly rate paid. A worker paid at a relatively high hourly rate will, nevertheless, have a fairly modest annual compensation from covered service if there are significant portions of the year during which he does not, or is unable to, secure employment in the plan's jurisdiction. On the other hand, a participant paid at a fairly modest hourly rate may have a comparatively high annual compensation if he is employed during all of the year and works a significant number of overtime hours. Moreover, the hourly rate paid and number of hours worked may vary widely for the same participant from year to year. Multiemployer plans often do not have access to this data. Thus, such plans would be unable even to determine the compensation levels of particular participants for a year, much less compare those levels to levels earned by nonparticipating employees of contributing employers to determine which are highly compensated.

Multiemployer plans would therefore usually be unable to compute the percentages necessary to prove that they satisfy any of the three seventy percent tests described above. Also, as discussed above, attempts by trustees to gather the information necessary to compute the percentage tests could prove disruptive for bargaining relations. Nevertheless, as discussed, such plans are not discriminatory. Accordingly, it is both important and appropriate to apply the new rules to multiemployer plans in a workable fashion which does not require them actually to compute percentages.

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[3] For this purpose, no more than 50 employees (or, if lesser, the greater of 3 employees or 10 percent of the employees) are treated as officers.

To help solve these problems, we urge you to provide a presumption that multiemployer plans satisfy the nondiscrimination rules and need not compute percentages to prove their compliance, except in specifically identified abuse situations. We suggest that you include the following provision in the technical corrections to the TRA for this purpose:

Subparagraph (F) of Paragraph (6) of Section 410(b) of the Internal Revenue Code is amended by adding at the end thereof a new sentence as follows:

> "Multiemployer plans shall be conclusively presumed to satisfy the nondiscriminatory coverage tests of this subsection and will not be required to compute percentages to demonstrate their compliance, except in situations, if any, specifically identified as abusive in such regulations.

In addition, we urge you to clarify in legislative history, if not in the statute, that employers can take credit for collectively bargained coverage when testing their nonbargained plans for nondiscriminatory coverage.

b. Welfare Plans.

Code Section 89, as added by section 1151 of the TRA, also imposes new nondiscrimination rules on statutory employee welfare benefit plans. Very generally, such plans must satisfy both an eligibility test and a benefit test. To demonstrate compliance with these tests, plan trustees would have to compare eligibility and benefit percentages for highly compensated employees with those of nonhighly compensated employees. As discussed above in the context of retirement plans, multiemployer plans are not discriminatory and, as a substantive matter, would have no trouble complying with the new nondiscrimination rules. Nevertheless, it ordinarily would be virtually impossible for such plans to demonstrate their compliance. As noted, this is because they typically do not have access to the information necessary to identify highly compensated employees and compute the required percentages.

To address these problems, we urge you to provide, in the context of welfare plans, a presumption similar to that discussed above with respect to retirement plans. We suggest the following language:

Subsection (m) of Section 89 of the Internal Revenue Code is amended by adding at the end thereof a new sentence as follows:

> "Multiemployer plans will be conclusively presumed to satisfy the nondiscrimination tests of this section and will not be required to compute the percentages necessary to demonstrate such compliance, except in situations, if any, specifically identified as abusive in such regulations."

In addition, we urge you to make clear in legislative history, if not in the statute, that employers can take credit for collectively bargained coverage when testing their nonbargained plans for nondiscrimination.

4. Section 415 Limit on Benefits Under a Defined Benefit Plan.

The TRA amends Code section 415(b)(5) to provide that the $90,000 (indexed) limit on benefits under a defined benefit plan is phased in over ten years of participation in the plan, instead of over ten years of service, as under prior law. The limit is required to be phased in separately with respect to benefit increases.

However, the term "year of participation" is not defined in the statute. This has led to confusion and an unjustifiably narrow interpretation by the Internal Revenue Service.

Accordingly, we urge you to define a year of participation for this purpose as any year during which an employee is at any time eligible to participate in the plan or during which an employee has at any time a vested present or future right to receive benefits under the plan. Statutory history should make clear that, under this definition, a full year of participation may be credited for a year during which the participant has insufficient service to accrue a benefit, to earn credit for vesting, or to avoid a break in service, or during which the participant is a terminated vested employee or a retiree.

We note that this is inconsistent with IRS Advance Notice 87-21, which states that a participant will be credited with a year, or partial year, of participation only for an accrual computation period during which: (1) the participant is credited with at least the number of hours of service, or period of service if the elapsed time method is used for benefit accrual purposes, required under the terms of the plan to accrue a benefit for the accrual computation period; and (2) the participant is included as a participant under the eligibility provisions of the plan for at least one day of the accrual computation period. Even if these two conditions are met, according to the notice, the participant will be credited only with that portion of a year of participation that equals the amount of benefit accrual service credited to the participant for the accrual computation period. Thus, for example, if, under the terms of a plan, a participant receives one-tenth of a year of benefit accrual service for an accrual computation period for each 200 hours of service, and the participant is credited with 1,000 hours of service for the period, the participant will be credited with one-half a year of participation for purposes of section 415(b).

This is an unjustifiably narrow definition of the term "participation". It would exclude individuals who participate in the plan, earn sufficient service credit to avoid having a break in service, but do not have sufficient service credit to earn benefit accruals -- *i.e.*, for most plans, individuals having more than 500 but less than 1,000 hours of service. It would also exclude terminated vested employees and retirees. All of these employees are clearly participants for many purposes of ERISA.

Their exclusion would not further, and in fact would frustrate, Congress' expressed purpose in modifying section 415. That purpose was to require employers, as a condition of providing the maximum benefits for highly compensated employees, to establish their plans at least ten years prior to the date such highly compensated employees retire, thus providing an opportunity for other employees to accrue (and become vested in) greater benefits.[4]

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[4] For example, the Senate Finance Committee Report states as follows:

> In addition, the Committee is concerned that the rule requiring reduced limits on benefits payable to participants with fewer than ten years of service is not effectively limiting benefits for highly compensated employees with short periods of plan participation. The Committee is aware that some employers are able to plan the timing of the establishment of a defined benefit plan (or an increase in benefits under a preexisting plan) to coincide with projected retirement of one or more of the employer's higly compensated employees. The effect of this delay is to avoid providing a comparable level of benefits to other employees who may have retired before the highly compensated employees. If, on the other hand, the defined benefit pension plan was established earlier so that the highly compensated employees accrued the maximum benefit over a longer period of service, rank-and-file employees would have accrued (and become vested in) greater benefits. Thus, the Committee finds it appropriate to require ten years participation in a defined benefit pension plan before the maximum benefits can be provided." S. Rep. No. 313, 99th Cong., 2d Sess., 623 (1986).

> Similarly, the House Report provides as follows:

> "In addition, the Committee is concerned that the rule requiring reduced limits on benefits payable to participants with fewer than ten years of service is not effectively limiting benefits for highly compensated employees with short periods of plan participation. The Committee is aware that some

[Footnote continued on next page]

This goal will be achieved if the maximum benefit limit is phased in over a ten-year period beginning on the date the employee initially becomes entitled to participate in the plan regardless of the employee's participation, service, benefit accrual, or other performance during that period. Imposing a more restrictive definition of "participation" is unnecessary and may adversely affect many of the nonhighly compensated employees -- e.g., retirees and terminated vested employees -- Congress intended the modification to benefit.[5]

We therefore urge you to include the following provision in the technical corrections to the TRA:

Paragraph (5) of Section 415(b) of the Internal Revenue Code is amended by adding a new subparagraph (E) at the end thereof as follows:

> "(E) YEAR OF PARTICIPATION DEFINED -- For purposes of this paragraph, a year of participation shall include any year during which an employee is at any time eligible to participate in the plan or during which an employee has at any time a nonforfeitable present or future right to benefits under the plan."

We suggest that the following language be included in legislative history explaining this provision:

> "Section 415(b)(5) requires the $90,000 (indexed) limit on benefits under a defined benefit plan to be phased in over ten years of participation in the plan and requires that limit to be phased in separately with respect to each benefit increase. For this purpose, a 'year of participation' includes any year during which an employee is at any time eligible to participate in the Plan or during which an employee has at any time a vested present or future right to receive benefits under the Plan. Thus, for example, a participant may be credited with a full year of participation for a year which is not yet completed, a year during which he or she has insufficient service to accrue a benefit, to earn vesting credit, or to avoid a break in service, or a year during which he or she is a terminated vested employee or a retiree."

In the event that you do not agree with the foregoing, we note that the Code includes break-in-service rules for determining when a participant can be required to start earning credit over

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[Footnote continued from previous page]

> employers time the establishment of a defined benefit plan (or an increase in benefits under a preexisting plan) to coincide with projected retirement of one or more of the employer's highly compensated employees. The effect of this delay is to avoid providing a comparable level of benefits to other employees who have retired prior to the highly compensated employee. If, on the other hand, the defined benefit pension plan was established earlier so that the highly compensated employee accrued the maximum benefit over a longer period of service, rank-and-file employees would have accrued (and vested in) greater benefits. Thus, the Committee finds it appropriate to require ten years of participation in a defined benefit paension plan before a participant can receive the maximum benefit." H. Rep. No. 426, 99th Cong., 1st Sess., 740-41 (1985).

[5] We also note that the definition of "participant" in Notice 87-21 is far more restrictive than the definition of "active participant", as set forth in Notice 87-16, which provides guidance with respect to individual retirement accounts. Notice 87-16 states that an individual is an "active participant" for a year if he is not excluded under the eligibility provisions of the plan, regardless of whether the individual has elected to decline participation in the plan, has failed to make a mandatory contribution specified under the plan, or has failed to perform the minimum service required to accrue a benefit under the plan.

again in order to participate. It would surely be anomalous to treat participants having sufficient service to avoid a break-in-service under the plan as failing, for 415 purposes, to participate in that particular year. We therefore urge you to provide, at a minimum, that participants having sufficient hours of service to avoid a break-in-service shall be treated as participants for purposes of section 415. A more restrictive, and less adequate, approach would be to provide that participants having the lesser of 1,000 hours of service or the minimum hours necessary under the plan for a year of vesting credit shall be treated as participants for purposes of section 415.

### 5. Applicability of Joint and Survivor Annuity Requirements to "Auxiliary" Disability Benefits.

Section 1898(b)(12)(A) of the Technical Corrections to the Retirement Equity Act of 1984 ("REA"), contained in the TRA amended Code section 417(f) to apply the joint and survivor rules to a disability benefit only if such benefit is not an "auxiliary" benefit. The Finance Committee's report provides an adequate definition of auxiliary benefit. The Finance Committee Report states:

> "If a participant receiving a disability benefit will, upon attainment of early or normal retirement age, receive a benefit that satisfies the accrual and vesting rules of section 411 (without taking the disability benefit payments up to that date into account), the disability benefit may be characterized as auxiliary.[6]

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[6] That report gives the following examples of the application of this definition:

> For example, consider a married participant who becomes disabled at age 45 with a deferred vested accrued benefit of $100 per month commencing at age 65 in the form of a joint and survivor annuity. If the participant is entitled under the plan to a disability benefit and is also entitled to a benefit of not less than $100 per month commencing at age 65, whether or not the participant is still disabled, the payments made to the participant between ages 45 and 65 would be considered auxiliary. Thus, the participant's annuity starting date would not occur until the participant attained age 65. The participant's surviving spouse would be entitled to receive a qualified preretirement survivor annuity if the participant died before age 65, and the survivor portion of a qualified joint and survivor annuity if the participant died after age 65. The value of the qualified preretirement survivor annuity payable upon the participant's death prior to age 65 would be computed by reference to the qualified joint and survivor annuity that would have been payable had the participant survived to age 65.
>
> If, in the above example, the participant's benefit payable at age 65 were reduced to $90 per month as a result of the disability benefits paid to the participant prior to age 65, the disability benefit would not be auxiliary. The benefit of $90 per month payable at age 65 would not, without taking into account the disability benefit payments prior to age 65, satisfy the minimum vesting and accrual rules of section 411 of the Code. Accordingly, the first day of the first period for which the disability payments were made would constitute the participant's annuity starting date, and any benefits paid the participant would be required to be paid in the form of a qualified joint and survivor annuity (unless waived by the participant with the consent of the spouse)." S. Rep. No. 313, 99th Cong. 2d Sess. 1094 (1986).

This definition should be incorporated into the legislative language to make its applicability clear.

In addition, the statute should make clear the point at which a joint and survivor annuity must or may be offered with respect to participants receiving auxiliary disability benefits. Applicable time frames for joint and survivor notices and elections should also be clarified. For example, will the recipient of an auxiliary disability benefit automatically begin receiving an actuarially reduced joint and survivor benefit at normal retirement age if he does not properly elect otherwise within 90 days prior to that time? In a plan offering an early retirement benefit, will the joint and survivor benefit begin, as it appears to us it should, at early rather than normal retirement age?

The statute should also expressly permit plans that have already been amended to provide joint and survivor annuities with respect to auxiliary disability benefits -- thus complying with REA as in effect prior to this technical correction -- to adopt amendments eliminating such annuities without running afoul of the REA anti-cutback rules. Otherwise, plans that acted promptly to comply with REA would be penalized as compared to plans that did not. We suggest that the following provision be added to the technical corrections to the TRA for this purpose:

(1) Special rule for Plans Providing Joint and Survivor Annuities with Respect to Auxiliary Disability Benefits as of the Date of Enactment of this Act. --

(i) Elimination of Joint and Survivor Form. Plans providing joint and survivor annuities with respect to auxiliary disability benefits as of the date of enactment of this Act may be amended, prior to the beginning of the first plan year beginning on or after January 1, 1989, to eliminate such joint and survivor benefits as to benefits not then in pay status.

(ii) Coordination with Internal Revenue Code section 411(d)(6), and section 204 of the Employee Retirement Income Security Act of 1984 -- An Amendment made pursuant to this subparagraph shall be deemed to satisfy the requirements of section 411(d)(6) of the Internal Revenue Code and section 204 of the Employee Retirement Income Security Act of 1974.

6. Effective Dates.

Many of the employee benefit provisions of the TRA provide extended effective dates for collectively bargained plans. However, most of these extensions apply only with respect to employees covered by a collective bargaining agreement. These include the: $7,000 limit on elective deferrals (TRA § 1105(i); minimum vesting standards (TRA § 1113(e)); minimum distribution requirements (TRA § 1121(d)); and nondiscrimination rules for coverage and benefits under certain statutory employee benefit plans (TRA § 1151(k)).

The purpose of the extension is to avoid requiring plan amendments before expiration of bargaining agreements, thereby forcing such agreements to be reopened and renegotiated. However, until subsequent negotiations determine the details of amendments with respect to bargaining unit participants, it will be impossible to draft amendments providing the same treatment for nonunion participants. In addition, application of new rules which inherently require all plan participants to be considered together, such as the welfare plan nondiscrimination rules, on a bifurcated basis would be impossible. Thus, the effect of the bifurcated effective date would, as a practical matter, likely to be thwart the intent of the extended effective date provisions.

Accordingly, we urge you to apply the extended effective dates for collectively bargained plans to all participants of such plans.

* * *

We appreciate your time and attention to these extremely important multiemployer issues. If you have any questions or if we can be of further help, please call Vivian Berzinski (202) 872-8610, or K. Peter Schmidt (202) 872-6834, of our professional staff.

Noble Lowndes Becker
Employee Benefit Consultants

Noble
Lowndes

July 9, 1987

Mr. Robert Leonard
Chief Counsel
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Dear Mr. Leonard:

I would like to direct the following comments to the Committee regarding the proposed Technical Corrections Act of 1987. Noble Lowndes Becker is an employee benefits consulting firm serving qualified benefit plans of over 1,000 clients. Resolution of the issues described below will assist these clients in conforming with the 1986 Tax Reform Act.

The first ten comments deal with problems raised by the 1986 Tax Reform Act which have not been corrected by the proposed Technical Corrections Act. The remaining items deal with new problems generated by the corrections.

1. Social Security Retirement Age:

   The definition of the Social Security Retirement Age to be used for Code Section 415 is fashioned by reference to the Social Security Act "without regard to the age increase factors". This translates to truncating the Social Security Retirement Ages to the next lowest full year. This is contrary to the ages specified in the Senate Finance Committee explanation which apparently were intended according to Congressional staffers (see enclosed article from The Pension Actuary).

2. $200,000 Compensation Limitation:

   The proposed Technical Corrections Act clarifies the application of the $200,000 compensation limitation for purposes of the family member aggregation rules with respect to plan years beginning after December 31, 1988. A similar clarification is needed for applying the $200,000 cap for purposes of the 401(k) and 401(m) testing of top-heavy plans for 1987 and 1988 plan years.

3. Tax on Excess Distributions:

   A clarification would be appreciated regarding the imposition of the Section 4981A tax on investment experience attributable to a participant's August 1, 1986 accrued benefit or account balance. If an individual has no additional benefit accrual or contribution after August 1, 1986, is the distribution of the entire benefit or account balance at a later date exempt or are the investment earnings subject to the tax?

4. Partial Rollover Rule:

   In redrafting this rule under Code Section 402(a)(5) to reference the "lump sum distribution" under 402(e), language dealing with the balance at the time of the distribution was dropped. Was this intended? Frequently we see benefits distributed in two payments which often straddle two calendar years. A terminee is permitted to draw down his fixed income account, for example, but must wait until after the end of the valuation period to be paid his equity account. It would seem to further portability objectives to permit the rollover of both payments, but this is not clear from the statute.

5. Determination of Highly Compensated Employees:

Unlike the determination of key employees under the top-heavy rules where individuals are identified as of the last day of the preceding plan year, the Highly Compensated Employee determination cannot be finalized until the end of the plan year for which the discrimination and coverage test are to be applied due to new hires, terminees, pay raises and bonuses. This is a significant stumbling block to attempts to monitor the 401(k) and 401(m) tests so as to avoid the need to make refunds and pay the 10% penalty. Adoption of the top-heavy approach, using the two plan years preceding the plan year to be tested, would alleviate this problem for administrators.

6. Withdrawals from 401(k) Principal:

Given that hardship withdrawals are limited to 401(k) contributions and not the investment experience attributable such contributions, computer systems must be modified to accumulate such amounts. It would be helpful if the account balance prior to the effective date of the new rule were grandfathered so that administrators need not reconstruct the information with respect to prior plan years.

7. Minimum Participation Rule:

Code Section 401(a)(26) provides that the new minimum participation rule must be satisfied on each day of the plan year. This is difficult to test from the plan administrator's point of view as well as difficult for the IRS to audit. Satisfaction of the rule on the first and/or last day of the plan year should be sufficient.

8. Code Section 415(e):

If these overly complex rules are to be retained, additional transitional rules should be provided. The calculation of the defined contribution fraction involves a great deal of historical data which in many cases has not been retained because it was clear, based on the prior limitations, that the restrictions would not apply. As a result of the significantly reduced defined benefit limit, many more individuals are potentially affected by the dual plan limits. This will undoubtedly generate significant administrative and auditing costs.

9. Retirement Equity Act Technical Corrections:

The five year repayment period was a welcomed clarification. However, the IRS apparently interprets Code Section 411 as requiring a cash-out or a five year break-in-service prior to the forfeiture of a terminated employee's forfeitable benefit. In most cases terminees are not rehired by the same employer. As a result the only way to access a forfeitable benefit is to cash-out the nonforfeitable benefit. This runs contrary to the objective of retaining the benefits for retirement purposes. Employers should be permitted to retain the nonforfeitable benefit in the plan while using the forfeitable portion for reallocation or the reduction of the required employer contribution as long as arrangements are made for restoring the forfeiture in the unlikely event the individual returns. Note that the immediate use of such forfeitures will have a favorable impact on the budget to the extent used to reduce current employer contributions.

10. 7,000 Deferral Limit:

Although plans are not required to make refunds as requested by employees, some practitioners believe there may be a fiduciary duty to do so. However, other rules may make it impossible to provide the refund even if the employer is willing to do so. For example, since the refund is deemed to come from the first contributions of the calendar year (typically), a refund to a non-highly compensated employee could reduce the average deferral percentage for highly compensated employees with respect to a plan year which has already ended. A refund to a highly compensated employee will apparently require the forfeiture of the match which has already been allocated and communicated with respect to a prior plan year. These problems would be alleviated if the plan is permitted to treat the distribution as an in-service withdrawal and is not required to adjust prior valuations in any way.

11. $200,000 Compensation Limitation - Integration Rule:

Guidance should be provided regarding the allocation of compensation in excess of the family group's aggregated integration level. The proposed Technical Corrections Act explains how the family members are added together, but does not explain how the resulting contribution/benefit (individually limited to $30,000/$90,000) is apportioned to the individuals.

12. COLA on $200,000 Compensation Limit:

The explanation to the proposed Technical Corrections Act indicates that this COLA starts in 1990 for post 1988 increases. However, Code Section 401(a)(17) indicates that this COLA is to be adjusted at the same time and in the same manner as under Section 415(d) which in turn provides for post 1987 increases.

13. Minimum Participation Rule - Terminations and Mergers:

Guidance is requested regarding the applicability of the "eligible amount" in the context of a plan merger in response to the minimum participation rule where two or more defined benefit plans are merged. Funds are not earmarked or distributed to plan participants in any way, nor are excess assets refunded to the employer. Unless a plan termination is undertaken in conjunction with a merger, it would seem that the reversion penalty and "eligible amount" restrictions are not relevant. As a result there is no need to reference mergers in the statute.

With respect to the actual determination of the present value, the rule should be clarified due to the change in the rate under Code Sections 401(a)(11) and 417. Plans which used the PBGC immediate annuity interest rate in accordance with IRS regulations and subsequently changed to the PBGC deferred annuity interest rate to conform to the 1986 Tax Reform Act should not be viewed as having changed their rate after August 16, 1986.

Last, but not least, the special rule for an annuity contract should be modified to provide for a unisex result. Contracts for females are more expensive than contracts for males and thus will unfairly generate a higher taxable amount under the rule as currently stated.

Your consideration of the points raised above is appreciated. I would be pleased to discuss any of these items in further detail if it would be of assistance to the Committee.

Sincerely yours,

Marjorie Martin

(Mrs.) Marjorie Martin
Assistant Vice President
Director, Research and Development

ington office staff for spending so many hours entering the data.

To order your copy of the Survey, please send us a check for $10.00 to cover the copying, postage and handling. Simply indicate on your letterhead "1986 ASPA FINANCIAL SURVEY."

## CORPORATIONS ELECTING S TREATMENT

*by Robert D. Lebenson, M.S.P.A.*

Numerous articles have been written pointing out the advantages to most closely held C corporations which qualify for the S corporation election to make that election by December 31, 1986. The advantages include lower tax rates, avoidance of a double tax on a liquidating sale of assets, and a more favorable basis to S corporation shareholders when they sell their stock.

It is important to note that there is a significant pitfall in some situations.

Outstanding plan loans to 5% shareholder-employees would become prohibited transactions once the election to S corporation status has been made, with the potential for plan disqualification. TRA'86 authorized DOL to issue exemptions in this area, but, obviously, any relief would not be effective until DOL acts. It is clear that DOL will not issue such exemptions before the end of this year. Therefore, it is important that any such loans be settled prior to the election of S corporation status.

## PREVIOUS ARTICLE ON SECTION 415 CHANGES UNDER TRA '86

We have had several inquiries about a possible discrepancy between the statutory language of TRA '86 and the interpretation in the above described article (Page 3 of the October, 1986 issue of The Pension Actuary) relating to the definition [redacted] purposes. The interpretation in the article reflects specific comments in the legislative history (Senate Finance Committee report, May 29, 1986). We have contacted Congressional staffers involved in the development of TRA '86, and they concur that the intent was to determine the Social Security retirement age for Section 415 purposes in accordance with the manner described in the article (utilizing the higher integral age, rather than the lower age, at intermediate points).

The reference to the 1983 GAM Table near the bottom of the right hand column in this article should have read 1983 IAM Table for females.

11/86

## CONFERENCE MATERIAL

A compilation of the material distributed to attendees at the 1986 ASPA Conference is available for purchase. If you desire this conference material, send your request with a check for $50.00 to the Washington office.

## TERMINATING DC PLANS TO AVOID NON-DEDUCTIBLE CONTRIBUTIONS

A letter dated November 7, 1986, has been mailed to all members concerning the above described subject. Enclosed please find an article responding to some comments received about this matter.

THE PENSION ACTUARY

**The Pension Actuary** is produced by the Executive Director, in conjunction with the Publications Committee of the American Society of Pension Actuaries.

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July 2, 1987

Mr. Robert Leonard
Chief Counsel
Committee on Ways and Means
U. S. House of Representatives
1102 Longworth House Office Building
Washington, DC 20515

Re: The Technical Corrections Act of 1987
(HR 2636/S 1350)-Pension Provisions

Dear Mr. Leonard:

This letter will highlight three ambiguities of the Tax Reform Act (TRA) which in our opinion are, inadequately addressed by the Technical Corrections Act of 1987 (TCA). We would appreciate your serious consideration of our suggested resolutions. The issues are as follows:

- Applying the defined benefit plan 10 year participation rule to combined plan limitations (Code Sec. 415(b) and 415(e))
- Inflation adjustments to the $200,000 compensation limit (Code Sec. 401(a)(17))
- Sunset provisions for plans terminating under Section 1112 of TRA

## The Ten Year Participation Rule

Under TRA, a reduced dollar limit applies to participants who have completed fewer than ten years of participation in a defined benefit pension plan (Sec. 415(b)(5)). Unfortunately, TRA did not address how this rule is applied in calculating the combined plan limitations for defined benefit and defined contribution plans (Code Sec. 415(e)).

In the case of a plan sponsor which terminates its defined benefit plan (which will number in the thousands as a result of TRA's Section 1112 new coverage requirements) a literal reading of current law will result in defined contribution limitations which are wholly unintended by Congress and restrictive in the extreme.

For example, if a super top-heavy defined benefit plan terminated on December 31, 1987 after three years the maximum annual benefit payable at the Social Security Retirement Age would be $90,000 x (3/10), or $27,000. If a participant had accrued a benefit of $27,000, his defined benefit fraction under Section 415(e) would be 27,000/27,000 or 1.0. The participant would then be forever precluded from receiving contributions under a defined contribution plan!

Note that if the participant were covered under another defined benefit plan instead of a defined contribution plan, he would continue to be able to accrue an annual benefit (Sec. 415(f)) at the rate of $9,000 per year for 7 more years.

The intent of Congress with respect to the 10 year participation rule was to limit the concentration of benefit accruals and associated deductible contributions to a period of at least 10 years, and not to punish participants of defined benefit plans terminated within 10 years. Furthermore, nowhere in the legislative history is there any intent of Congress to favor the establishment of defined benefit plans over defined contribution plans.

The IRS publicly acknowledged at the 1987 Enrolled Actuaries Meeting that they deliberately ignored this entire problem when they issued Notice 87-21, because they recognized that any equitable interpretation of this provision would be inconsistent with a literal reading of the law.

I am flabbergasted that TCA does not address this contradictory inequity and leaves it to regulations, particularly since the people who will be drafting these regulations have already acknowledged their own confusion on the matter.

The correction to this problem we believe is an easy one. It preserves the intended limitations prescribed by the 10 participation rule but by the same token eliminates the unintended punishment described above. We propose that Sec. 415(e)(2)(B)(i) be amended as follows:

> "(i) the product of 1.25, multiplied by the dollar limitation in effect under subsection (b)(1)(A) for such year (without regard to subparagraph (b)(5))

The effect of this amendment in the example described above would be to reduce the fraction to 27,000/90,000, or .3. This amendment would allow the defined contribution limit to be calculated using similar procedures that have been in effect since ERISA and which Congress, by its silence in TRA's committee reports, intended to preserve.

## Inflation adjustments To The $200,000 Compensation Limit

Under Sec. 401(a)(17), the annual compensation taken into account under a qualified plan cannot exceed $200,000. The law also states, "The Secretary shall adjust $200,000 amount at the same time and in the same manner as in Sec. 415(d)". Section 415(d) clearly indicates that such adjustments shall begin on January 1, 1988 using the fourth quarter of 1986 as a base period for purposes of calculating inflation increases. The limit is generally effective for plan years beginning in 1989.

One would expect, as an example, that if inflation increased at a rate of 5% per year from the last quarter of 1986 to the first quarter of 1989 that the $90,000 defined benefit limit would be increased by a factor of 1.05 x 1.05, or 1.1025. Similarly, the $200,000 limit being adjusted at the same time and in the same manner, would be adjusted by the same factor to an amount equal to $220,500 as of January 1, 1989.

The Joint Committee's explanation of present law that, "This $200,000 limit is to be adjusted beginning in 1990 for post 1988 cost of living increases...." is, in our opinion, without foundation and a misreading of both the letter and the intent of the law. The Senate Committee report, which the conference agreement follows, says, "The $200,000 limit presently applicable to top-heavy plans and SEP's is applied to all qualified plans". By way of 415(d), Sec. 416(d) (regarding compensation for top-heavy plans), provided that cost of living adjustments were scheduled to take place in 1988, not 1990.

Therefore, we recommend that TCA clarify Section 401(a)(17) to explicitly provide that such cost of living adjustments shall be effective January 1, 1988 to reflect cost of living increases after October 1, 1986.

TCA Section 111(d) provides that increases in the $200,000 limit may not be taken into account before they occur in determining the deductible limit for contributions to a qualified plan. We believe this provision can only further erode the dangerously funded status many of the nation's qualified defined benefit plans and undermines the entire thrust of the administration's and PBGC's proposals to bolster the funding of defined benefit plans.

Furthermore, this provision can only further jeopardize the benefits of the very participants which it is trying to protect. Participants earning more than $200,000 are generally closer to retirement than non-highly compensated employees. As the compensation limit increases, benefit accruals for these highly compensated employees will also increase. However, since plan sponsors under this provision will be precluded from prefunding for these increases, some or all of the contributions necessary to fund these increases will not be available to pay benefits until after the benefit payments have been made. Therefore, the funds will have to come from existing plan assets and the funded status of the plan for remaining plan participants will be worse.

Furthermore this provision is not a technical correction and therefore irrelevant to the bill's purpose. We strongly recommend that this provision be deleted from TCA.

Sunset Provisions For Terminating Defined Benefit Plans

TRA Section 1112(e)(3) provides for a waiver of excise tax attributable to reversions from defined benefit plans that do not satisfy the new coverage requirements under Code Sec. 401(a)(26). While it is uniformly agreed that no reading of this TRA section is reasonable as written, we believe that it was intended as an optional grandfather provision which employers may employ in order to avoid the excise tax. Employers may decide to be subject to the excise tax if they did not comply with Section 1112(e)(3)(A) of TRA.

In any event, TCA proposes a new set of rules to tax deferred defined benefits which were accrued prior to TRA.

While the legislative history since ERISA is filled with numerous cutbacks and restrictions to savings in qualified plans, Congress has invariably gone out of its way to protect tax deferred benefits already accrued, because it recognized that if it ever changed the rules retroactively, it would destroy the trust which employers hold with respect to the tax system as it relates to qualified plans. Congress has historically gone to great lengths to protect retroactively accrued benefits, in particular accrued benefits under defined benefit plans (e.g., amendments to Section 415(b)(1)(a) under ERISA, TEFRA and TRA). Each act explicitly stated that if prior requirements of Section 415 were met, then prior accrued benefits would be preserved. We believe the same philosophy should be adopted under TRA's Section 1112(e)(3), and without any new rules!

In our opinion any new provisions which threaten previously accrued tax deferred benefits will alienate employers sponsoring both small and large plans, and indefinitely discourage the establishment of qualified retirement programs in the United States.

Thousands of pension plans were established since 1981 which have complied and continue to comply with the prior coverage requirements under Code Section 410 and the "comparability" requirements of Revenue Ruling 81-202. This Revenue Ruling sanctioned the tailoring concept of qualified plans to meet the objectives of employee sub-groups of the employer.

Through its silence in TEFRA, DEFRA and REA Congress gave its imprimatur to this concept. Pension plans covering common law employees have thrived as a result. Congress will hasten their demise if it fleeces the pockets of the people who foot the bill.

We hope that Congress appreciates the gravity of these issues, and we look forward to an equitable TCA.

Sincerely,

Leonard Levitt

## PROFIT SHARING COUNCIL OF AMERICA
## RECOMMENDATIONS FOR H.R. 2636,
## THE TECHNICAL CORRECTIONS ACT OF 1987

The Profit Sharing Council of America recommends the following changes and clarifications be included in H.R. 2636, the Technical Corrections Act of 1987.

### Additional Tax on Excess Distributions

1. The special grandfather rule under Sec. 4981A(c)(5) allows an employee to elect to "grandfather" the amount of his accrued benefits as of August 1, 1986. Most profit sharing plans do not value employee accounts monthly. Some value quarterly, and most value annually. It is recommended that participants be allowed to grandfather their accrued benefits as of the end of the first plan quarter ending after August 1, 1986, for those plans which value quarterly, or the end of the first plan year ending after August 1, 1986, for those plans valuing once a year. The Council also recommends that all future income attributable to the grandfathered amount be part of the grandfathered amount.

An employee who elects the special grandfather for accrued benefits as of August 1, 1986, will be denied the $150,000 limit under Sec. 4981A(c)(5)(C) or the $750,000 limit on lump sum distributions. The election of the special grandfather should not deprive the retiree from the use of the substitute $150,000 limit. This forces an employee to make an election years before a distribution is made. The Council recommends that an employee be allowed to elect the $150,000 special limit in the year of retirement. Moreover, the election of this grandfather should not be required until the year of the distribution. In 1987 or 1988, most employees will not have the information available in order to make a meaningful election.

2. The excess distribution as defined under Sec. 4981A(c)(2) would apparently require the inclusion of net unrealized appreciation in distributed employer securities as part of the excess distribution. This would include net unrealized appreciation which is excludable from a lump sum distribution under Sec. 402(e)(4)(J).

Reason dictates that the excise tax apply only to amounts includible in taxable income. This is supported by reference to the House Bill H.R. 3838, Sec. 1133, which is explained by the Report of the Committee on Ways and Means 99-426, December 7, 1985, at page 745.

That Report says, in part, at page 745:

> In applying the limit, aggregate annual distributions made with respect to a participant from all pension, profit-sharing, stock bonus, and annuity plans, ESOPs, individual retirement accounts and annuities (IRAs), and tax sheltered annuities generally are taken into account to the extent includible in gross income. (Emphasis added.)

The use of employer securities in profit sharing plans has long been treated favorably under the Code in recognition of the value of the employee ownership of the employer, both as an incentive to foster the welfare of the employer and to instill the pride of proprietary interest in the employees. Levying an excise tax on unrealized appreciation in distributed employer securities would be an unwarranted and unsupported diminution of that historical favorable treatment.

3. Sec. 4981A(c)(4) allows a taxpayer to use five times the amount of the limitation, or $750,000, in calculating his limitation if the taxpayer elects income averaging for a lump sum distribution under Sec. 402(e)(4)(B). A taxpayer may lose the right to elect income averaging if he has previously elected such averaging, or has made an IRA rollover of a partial distribution in the past. The Council urges that an employee should not be deprived of the special higher limit on lump sum distributions even though he is not able to elect the special averaging.

4. Sec. 4981A(c)(5) should be clarified to provide that the grandfathering applies to amounts held in IRAs, especially those IRAs which have received rollovers from qualified plans.

5. The Council recommends that Sec. 4981A(d) should be amended to allow for a deduction for the marital deduction under Sec. 2056 and the unified credit under Sec. 2010. In many cases, the amount in the qualified profit sharing plan or a rollover IRA is a major part of the estate of the deceased employee or retiree. This property is generally left to the surviving spouse. It seems unjust to impose the excess distribution penalty tax in these cases.

## Extension of Special 5-year Averaging to Early Retirees

Sec. 72(t) waives the 10% early distribution penalty on lump sum profit sharing distributions before age 59½ if the employee retires under the terms of the plan after attaining age 55. However, between the ages of 55 and 59½, the employee would not be eligible for the special 5-year averaging for his lump sum distributions. The special 5-year averaging should be extended to these retirees.

Age 55 is considered early retirement age by most employers. Many thousands of employees retire at age 55, take lump sum distributions of their profit sharing accounts, and use the proceeds for retirement until age 62 when their Social Security benefits commence. Many profit sharing plans provide only lump sum distributions. It is entirely inconsistent to allow employees to retire early without penalty, but not allow them the special 5-year averaging on their lump sum distributions from their qualified profit sharing plans.

Congress recognized that early retirees should not be subject to the early distribution penalty. The intention was to allow employees the opportunity to retire at age 55 without penalty. The omission of special 5-year averaging was apparently an oversight and will act as a severe penalty on this group of retirees. The Code should be corrected to give the early retirees the intended protection.

The reduction to age 55 will have no adverse revenue effect. In fact, in the future it will enhance revenues because employees will not be encouraged to postpone their retirements and to delay receiving their lump sum distributions. Further, Sec. 1122(h)(3) of the Tax Reform Act provided a transitional rule for all employees who were age 50 on January 1, 1986. Therefore, extending the 5-year averaging to early retirees will have no revenue effect until at least 1991.

## Lump Sum Distributions

Sec. 1122(h)(4) of the Tax Reform Act provides for a 5-year phase out of capital gains treatment for pre-1974 accumulations. The bill is silent as to the rate of tax applicable under the 5-year phase out. Sec. 1122(h)(3)(B) provides for a 20% tax on the capital gains portion of a lump sum distribution for an individual who attained age 50 before January 1, 1986. It is recommended that the Act be clarified to allow a 20% tax rate on the phase out of the capital gains treatment for those individuals who were not born before January 1, 1936.

There should also be a correction of the method for calculating the 5-year averaging on lump sum distributions under Sec. 402(e). Commencing in 1988, the 15% tax rate will start to be phased out under the single individual tax tables when the taxable amount exceeds $43,150. From $43,150 to $89,560 of taxable income, the marginal rate will be 33%. It is recommended that the phase out of the 15% tax rate should not be taken into account when calculating the tax under the 5-year income averaging. The phase out of the 15% tax rate will undoubtedly substantially increase the tax on many lump sum distributions and virtually eliminate any benefits such treatment might otherwise give the employee. This would certainly be contrary to the Congressional intent in providing equitable tax treatment for lump sum distributions. These distributions often represent accumulations over the employee's entire working career.

## Sec. 401(m)(9) Multiple Use of the Alternative Limitation

Sec. 401(m)(9) provides that the Secretary may prescribe regulations to prevent the multiple use of the alternative limitation with respect to any highly compensated employee. The alternative limitation is apparently the 200%/2 percentage points limitation described in Sec. 401(m)(2)(A)(ii).

The non-discrimination test became effective on January 1, 1987. For many plan sponsors the calculation of this test is complex and, in the absence of regulations prescribing the details on such calculations, many employers will undoubtedly make errors. Discovery of the errors in the future can result in substantial penalties. Therefore, it is recommended that the effective date for any prohibition on the multiple use of the alternative limitation should be delayed until after the final regulations are promulgated by the Secretary. The effective date should be delayed until the beginning of the first plan year following the adoption of such final regulations.

In addition, the final regulations should not restrict the use of the alternative limitation under Sec. 401(m) unless there is in fact a multiple use of the same contribution, such as a qualified nonelective contribution, under both Sec. 401(m) and under Sec. 401(k).

Loans

Sec. 72(p)(2)(C) requires "level amortization" of loans. It is unclear whether level amortization means level amortization of principal, or equal payments of principal and interest over the life of the loan. Normally, loans are repaid with equal payments. The first payments generally consist of higher amounts of interest which will decrease in subsequent payments as the principal balance decreases. It is recommended that Sec. 72(p)(2)(C) be clarified to allow level payments over the life of the loan.

Sec. 72(p)(3)(B)(ii) provides that interest is not deductible to the extent it is attributable to elective 401(k) deferrals. In many cases, a loan is secured by the non-401(k) portion of an account as well as the elective 401(k) deferral portion of the account. Thus if any part of a loan is secured by the elective 401(k) deferral, this will taint the entire interest deduction. It is recommended that the interest deduction be denied only to the extent of the loan balance that is secured by the elective 401(k) deferral.

Sec. 72(p)(3)(B) also denies an interest deduction for a loan to a key employee as defined in Sec. 416(i). This latter section includes as a key employee any employee who satisfied the test in the plan year or any of the four preceding plan years. This definition is too broad for the purpose of denying the interest deduction. The determination of a key employee for this purpose should be based on the status of the employee as of the last day of the year preceding the first day of the plan year.

Definition of Compensation

The Technical Corrections Act of 1987 in Sec. 111(k) would make a substantive change to present law.

Sec. 414(s) presently allows the employer to elect to include any salary reductions under Secs. 125 and 401(k) as compensation for all purposes under Part I of Subchapter D of the Code.

The Technical Corrections Act would eliminate this election with respect to the definition of compensation under Sec. 415(c).

This substantive change would have little or no impact on higher-paid employees who are limited by the $30,000 maximum annual addition. However, for lower-paid employees this would reduce the compensation base upon which the 25% maximum annual addition under a defined contribution plan is determined. The ability of lower-paid employees to save for their retirement should not be sacrificed to achieve greater uniformity. As a result, it is recommended that this substantive change not be made.

ESOPs and PAYSOPs -- Diversification Requirements

Sec. 401(a)(28) requires diversification of investments in PAYSOPs and ESOPs for employees approaching retirement. Many profit sharing plans include tax credit PAYSOPs. The Tax Reform Act terminated the tax credit after December 31, 1986. Most plan sponsors will not make their 1986 contribution to the PAYSOP until 1987, when the total compensation of participants is determined. The contribution will then be invested in employer securities.

The effective date for the diversification requirements applies to stock acquired after December 31, 1986. Under most PAYSOPs, after the employer stock is purchased with the 1986 contribution, no further stock purchases will be made except for the reinvestment of dividend income on the stock then held. Requiring the diversification for the stock attributable to the 1986 contribution will impose substantial administrative burdens on most plan administrators. It is strongly recommended that the effective date of Sec. 401(a)(28) be clarified so that the contributions for 1986, which are made in 1987, and future purchases of employer stock by reinvestment of dividends should not be subject to the diversification requirements.

Respectfully submitted,

David L. Wray
President

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July 17, 1987

Robert J. Leonard, Esquire
Chief Counsel, Committee on Ways and Means
U.S. House of Representatives
Washington, D.C. 20515

Re: Technical Corrections Act of 1987
(H.R. 2636)

Dear Rob:

The following comments are submitted on behalf of the Teachers Insurance and Annuity Association (TIAA) and College Retirement Equities Fund (CREF) for consideration by the Committee on Ways and Means with respect to H.R. 2636, the Technical Corrections Act of 1987. These comments, as described in more detail below, suggest technical corrections concerning several pension issues.

I. Section 1105 of the Tax Reform Act

Section 3121(a)(5)(D) of the Internal Revenue Code (the "Code") defines amounts which are treated as wages and includible in the social security wage base for FICA tax as including any contributions to a 403(b) annuity contract which is made by reason of a salary reduction agreement, whether or not evidenced by a written instrument. Neither section 3121(a)(5)(D) nor the legislative history behind its enactment makes any distinction between mandatory, required or voluntary 403(b) salary reduction contributions. Employers generally treat all 403(b) salary reduction contributions as subject to FICA tax even if such contributions are required under the employer's plan.

Section 402(g) of the Code provides that the total amount of elective deferrals contributed annually on behalf of an employee to all 403(b) annuity contracts is limited to $9,500. Section 402(g)(3)(C) of the Code defines "elective deferral" for purposes of the $9,500 limit as including any employer contribution to purchase a 403(b) annuity contract under a salary reduction agreement within the meaning of section 3121(a)(5)(D).

However, the language contained in both the Conference Report accompanying H.R. 3838 (H.Rept. 99-841, 99th Cong., 2nd Sess., 405, 410 (1986)) (the "Conference Report") and General Explanation of the Tax Reform Act of 1986, JCS-10-87, 662 (1987) (the "Bluebook") indicates that mandatory or required 403(b) salary reduction contributions will not be treated as "elective deferrals" for purposes of the $9,500 annual limit.

The conflict between the statutory language and the statement of Congressional intent as reflected in the Conference Report and Bluebook explanations should be resolved. A technical correction to section 402(g)(3)(C) of the Code is recommended to conform the statutory language to the Congressional intent, to provide in (C) that: "Any employer contribution to purchase an annuity contract under section 403(b) under a salary reduction agreement (within the meaning of section 3121(a)(5)(D)) except that such term shall not include contributions that are required under the employer's plan and that are made by salary reduction as determined under regulations prescribed by the Secretary." (Proposed statutory correction underscored.)

II. H.R. 2636 (the "bill") contains an inaccurate reference in section 111A(b)(11), which provides that a new paragraph (9) is added at the end of Section 1123(h) of the Tax Reform Act of 1986 (the "Act"). The correct reference to the section of the Act to which a new paragraph (9) will be added should be Section 1122(h).

III. Section 1123(e)(2) of the Act

The bill proposes a technical correction to section 1123(e)(2) of the Act with respect to the 1989 restrictions on distributions attributable to 403(b) "elective deferrals" (as defined in section 402(g) of the Code). That proposed correction appears to include a new grandfathering rule for the 1989 restrictions on distributions by providing that such restrictions shall only apply to distributions from 403(b) annuity contracts which are attributable to assets other than assets held as of the close of the last year beginning before January 1, 1989. Therefore, it appears that the restrictions on distributions attributable to 403(b) elective deferrals do not apply to pre-1989 403(b) elective deferrals, including pre-1989 interest attributable to such elective deferrals. This special rule presents problems in identifying, tracking, and allocating the grandfathered 403(b) elective deferrals and earnings. The proposed technical correction language should be revised to reflect more clearly the 403(b) elective deferrals and the amount of the earnings on those amounts determined as at the close of the last year beginning before January 1, 1989 (i.e., rather than referring to "assets"). Alternatively, the technical correction could provide that the 1989 restrictions do not apply to the value under any 403(b) annuity determined as at the close of the last year beginning before January 1, 1989.

IV. Section 1852 of the Act

Section 1852 of the Act extends the 401(a)(9) qualified plan distribution rules to 403(b) annuities for "benefits accruing after December 31, 1986." There had been some speculation that the proposed technical corrections might either clarify the term "benefits accruing after December 31, 1986" or repeal the grandfathering rule for benefits accrued prior to 1987, thereby extending the qualified plan distribution rules to 403(b) annuities irrespective of when such benefits accrued. However, the bill as introduced does not include either of these provisions.

It is recommended that technical corrections specifically define the term "benefits accruing" for purposes of identifying 403(b) amounts not subject to the qualfied plan required distribution rules. For example, one should be able to determine whether or not benefits accrued prior to 1987 merely mean the accumulation value under the 403(b) annuity as of December 31, 1986.

## V. Section 1123 of the Act

It is recommended that a technical correction be sought to Section 1123(a) of the Act concerning the exception to the 10% additional tax under section 72(t)(2)(A)(iv) for lifetime annuities commencing after an employee separates from service to include lifetime annuities which begin under a phased retirement.

A technical correction should also be sought to Section 1123(e)(3) of the Act to extend such exception from the 10% additional tax under section 72(t) to individuals who were in pay status as of March 1, 1986, under an irrevocable election for lifetime annuities but who had not separated from service with the employer as of March 1, 1986.

## VI. Sections 1105 and 1117 of the Act

The bill would amend Section 1105 of the Act to provide that income on excess deferrals which are distributed before the applicable April 15 date, including income earned during and after the year to which the deferral relates, is includible in income in the year distributed rather than in the year to which the deferral relates as is currently provided. However, Section 1117(b) of the Reform Act, relating to 401(k) contributions, employer matching contributions and employee contributions, provides that excess contributions (plus earnings) and excess aggregate contributions (plus earnings) that are distributed within 2-1/2 months after the end of the plan year are treated as received and earned by the recipient (i.e., employee) in the taxable year to which the contribution relates, subject to a *de minimis* exception which was added under the bill.

The bill apparently intends that income on excess deferrals distributed under section 402(g)(2) of the Code will be includible in the recipient's gross income in the year distributed whereas income on excess 401(k) contributions, on excess aggregate contributions as defined in section 401(m) of the Code, or on certain other excess contributions as defined under section 4979 of the Code, will be generally includible in income in the taxable year to which the contribution relates. It is recommended that the rules relating to the taxable year for inclusion in gross income of income allocable to excess deferrals (section 402(g)(2) and income allocable to excess aggregate contributions and excess contributions under section be made consistent. The inclusion of earnings in the year distributed (rather than the year to which the excess contribution relates) is easier to administer and would reflect the fact that a portion of the earnings may in fact have been earned in the year of distribution.

Barbara Seymon-Hirsch of TIAA/CREF would be happy to answer any questions or discuss this matter with your or your staff. She can be reached at (212) 916-4663.

Respectfully submitted,

Dewey, Ballantine, Bushby,
Palmer & Wood

By: Felix B. Laughlin
Felix B. Laughlin

Section 1101

UNIVERSAL
PENSIONS, INCORPORATED
RETIREMENT ACCOUNT SPECIALISTS

June 23, 1987

Robert Leonard, Chief Counsel
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Re: Tax Reform Act of 1986 §1101
Addition of Internal Revenue Code (IRC) §219(g).

Dear Mr. Leonard:

Please note the technical error created at Tax Reform Act of 1986 §1101, which was not corrected by the Technical Corrections Bill of 1987 §111(a).

IRC §219(g)(1) defines the "maximum deductible limit" for the purposes of determining the amount eligible to be deducted for contributions to an IRA. IRC §219(g)(1) defines the limit as that found at IRC §219(b)(1)(A) and IRC §219(c)(2). This creates an inconsistency as IRC §219(b)(1)(A) is $2,000 and IRC §219(c)(2) is the lesser of $2,250 or an amount equal to the compensation includible in the individual's gross income for the taxable year.

Obviously, IRC §219(g)(1) was intended to specify either IRC §219(b)(1)(A) (i.e., $2,000) and IRC §219(c)(2)(A)(i) (i.e., $2,250) or IRC §219(b)(1) (i.e., the lesser of $2,000 or an amount equal to the compensation includible in the individual's gross income for the taxable year) and IRC §219(c)(2) (i.e., the lesser of $2,250 or an amount equal to the compensation includible in the individual's gross income for the taxable year), whichever reflects your intent. The Internal Revenue Service has already endorsed the first alternative (see IRS Notice 87-16, I.R.B. 1987-5 and IRS Announcement 86-121, I.R.B. 1986-50). If you wish to discuss this technical error with me, please call me at (218) 829-4781.

Sincerely,

UNIVERSAL PENSIONS, INC.

Theordore K. Rice
Attorney

Universal Pensions, Inc. has provided products and services to financial institutions that offer qualified retirement plans and individual retirement accounts since 1975. Currently, Universal Pensions, Inc. provides products and services to over 5,000 financial institutions nationally.

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## Section 1105

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## MEMORANDUM

TO: Ways and Means Committee

FROM: Preston, Thorgrimson, Ellis & Holman

DATE: July 16, 1987

RE: Technical Corrections Act; Limitation on Elective Deferrals under 403(b) Tax Deferred Annuity

---

Section 402(g)* of the Internal Revenue Code of 1986 (the "Code"), as added by Section 1105(a) of the Tax Reform Act of 1986 (the "Act"), imposes a $9,500 limit on "elective deferrals," including:

> "...any employer contribution to purchase an annuity contract under section 403(b) under a salary reduction agreement (within the meaning of section 3121(a)(5)(D))." (Code § 402(g)(3)(C).)

Under this Code language, all contributions made by salary reduction agreement (including those made as a condition of employment) are subject to the $9,500 limit.

The Conference Committee Report on the Act (the "Report"), which has the effect of law since it is part of the official legislative history of the Act, contains the following:

> "...[I]f an employee is required to contribute a fixed percentage of compensation to a tax-sheltered annuity as a condition of employment, the contributions are not treated as elective deferrals."

The language of the Report reflects a legislative intent that is contrary to the inclusive language used in the Act. The legislative intent appears to have been to distinguish between "elective" and "required" employee contributions, the latter (whether pre-tax or after-tax) being more of the nature of an employer contribution since the employee is given no choice but to contribute part of his/her compensation. The "Blue Book" (Joint Committee Explanation of the Act) does not clarify the effect of the $9,500 limit on an employee who is required to contribute a fixed percentage of compensation to an annuity contract as a condition of employment. Therefore, it is impossible to advise clients concerning the application of the limits on such an employee's contributions.

We ask that the inconsistency between the Report and the Act be remedied by codifying the language from the Report in the form of an amended Code section 402(g)(3)(C)* in the Technical Corrections Act as follows:

* Note: There are three Code Sections 402(g) after amendments made by the Tax Reform Act of 1986.

> "(C) any employer contribution to purchase an annuity contract under section 403(b) under a salary reduction agreement (within the meaning of section 3121(a)(5)(D) except to the extent the employee is required to contribute a fixed percentage of compensation to an annuity contract as a condition of employment."

Since this additional language would simply incorporate the original congressional intent, as expressed in the Report, no revenue impact would result from this additional language.

For your convenience, we attach:

(1) Relevant sections of the Report;

(2) Relevant section of the Act;

(3) Relevant section of the "Blue Book"; and

(4) Legislative Language for Technical Corrections Act.

---

Legislative Language for
Technical Corrections Act

Internal Revenue Code Section 402(g)(3)(C)*, as added by Section 1105(a) of the Tax Reform Act of 1986, is amended to read as follows:

> "(C) any employer contribution to purchase an annuity contract under section 403(b) under a salary reduction agreement (within the meaning of section 3121(a)(5)(D)) except to the extent the employee is required to contribute a fixed percentage of compensation to an annuity contract as a condition of employment."

* Note: There are three Code Sections 402(g) after amendments made by the Tax Reform Act of 1986

tions and State and local governments (or a political subdivision of a State or local government) from establishing qualified cash or deferred arrangements is adopted.

The conference agreement provides that this provision does not apply to plans adopted before (1) May 6, 1986, in the case of an arrangement maintained by a State or local government (or political subdivision of a State or local government), or (2) July 2, 1986, in the case of an arrangement maintained by a tax-exempt organization. The grandfather treatment is limited to the employers who adopted the plan before the dates specified above. However, the grandfather treatment is not limited to employees (or classes of employees) covered by the plan as of the date the grandfather treatment is provided.

The provision is effective for years beginning after December 31, 1986. However, in the case of a plan maintained by a State or local government that was adopted before May 6, 1986 (and is, therefore, eligible for the grandfather rule), the following provisions in the conference agreement applicable to qualified cash or deferred arrangements do not apply until years beginning after December 31, 1988: (1) the modification of the special nondiscrimination tests, (2) the new definition of highly compensated employees, (3) the new definition of compensation, and (4) the rule aggregating highly compensated employees.

### *Definition of compensation*

The conference agreement adopts a uniform definition of compensation for purposes of applying the special nondiscrimination requirements, effective for years beginning after December 31, 1988. [*See* ¶ 8114.]

## [*Tax-Sheltered Annuities*]

## [House Committee Report]

### Elective Contributions Under Tax-Sheltered Annuities

### *Limit on elective deferrals*

Under the bill, the maximum amount that an employee can elect to defer for any taxable year under all tax-sheltered annuities in which the employee participates is limited to $7,000 [The Conference Bill raises the amount for tax-sheltered 403(b) annuities]. Whether or not an employee has deferred more than $7,000 a year is determined without regard to any community property laws. In addition, the $7,000 limit is coordinated with elective 401(k) deferrals and the annual deduction limit for IRA contributions.

Unlike the overall limits on annual additions, which apply separately to amounts accumulated under plans of different employers, this $7,000 cap limits all elective deferrals by an employee. Thus, the $7,000 limit applies to aggregate deferrals made under all tax-sheltered annuity programs and cash or deferred arrangements in which the employee participates. [The Conference Bill clarifies the definition of elective deferrals.]

Because this $7,000 limit applies only to elective deferrals, each employer may make additional contributions on behalf of any employee to the extent that such contributions, when aggregated with elective deferrals made by the employee under that employer's tax-sheltered annuity during the limitation year, do not exceed the exclusion allowance or the overall limits on contributions and benefits.

If, in any taxable year, the total amount of elective deferrals contributed on behalf of an employee to any tax-sheltered annuities and qualified cash or deferred arrangements in which the employee participates exceeds $7,000, then the amount in excess of $7,000 (the excess deferrals) [is] included in the employee's gross income for the year. In addition, with respect to any excess deferrals, by March 1 after the close of the employee's taxable year, the employee may allocate the excess deferrals among the tax-sheltered annuities in which the employee participates and notify the administrator of each program of the portion of the excess deferrals allocated to it. Further, not later than April 15 after the close of the employee's taxable year, each program is to distribute to the employee the amount of the excess deferrals (plus income attributable to the excess) allocated to the plan. This distribution of excess deferrals may be made notwithstanding any other provision of law.

The committee intends that the tax-sheltered annuities maintained by any single employer should preclude an employee from making elective deferrals under the program for any taxable year in excess of $7,000.

The amount of excess deferrals distributed to an employee (plus the income on the excess deferrals) [is] included in the employee's income for the year to which the excess deferrals relate. However, the amounts are treated as if they had not been contributed to the tax-sheltered annuity program and, therefore, are not subject to any additional income taxes for early withdrawals.

Excess deferrals that are not distributed by the applicable April 15 date are not treated as employee contributions upon subsequent distribution even though such deferrals had been included in the employee's income.

### *Special catch up election*

Finally, the bill provides an exception to the $7,000 annual limit (but not to the otherwise applicable exclusion allowance (sec. 403(b)) or the overall limit on contributions and benefits (sec. 415) in the case of employees of an educational organization, a hospital, a home health service agency, or a church, convention or association of churches. Under this exception, any eligible employee who had completed 15 years of service with the employer would be permitted to make an additional salary reduction contribution under the following conditions:

(1) In no year can the additional contributions be more than $3,000;

(2) An aggregate limit of $15,000 applies to the total amount of contributions that, in any year, exceed $7,000; and

(3) In no event can this exception be used if an individual's lifetime elective deferrals exceed the individual's lifetime limit.

The lifetime limit on elective deferrals for an individual, solely for purposes of the special catch-up rule, is $5,000 multiplied by the number of years of service that the individual performed with the employer.

### *Effective Dates*

The provisions generally are effective for years beginning after December 31, [1986]. A special effective date is provided in the case of a tax-sheltered annuity program maintained pursuant to one or more collective bargaining agreements ratified before [March 1, 1986], between employee representatives and one or more employers. Under this special rule, the provisions do not apply to contributions made under such an agreement in taxable years beginning before the earlier of (1) the date on which the last of the collective bargaining agreements terminates or (2) January 1, [1989].

## [Conference Committee Report]

### Elective Contributions Under Tax-Sheltered Annuities

#### *Limit on elective deferrals*

The conference agreement follows the House bill, except that the annual limit on elective deferrals under a tax-sheltered annuity is increased to $9,500. The $9,500 limit applies until the cost-of-living adjustments to the annual limit on elective deferrals under a qualified cash or deferred arrangement raise that limit from $7,000 to $9,500, at which time the limit on elective deferrals under a tax-sheltered annuity is also indexed in the same manner as the indexing of the annual limit for elective deferrals under a qualified cash or deferred arrangement.

The conference agreement clarifies the definition of elective deferrals to which the annual limit applies. In the case of an employer that allows employees a one-time election to participate in a contributory defined benefit pension plan with a single mandatory contribution rate or a tax-sheltered annuity program with elective deferrals, neither the election of an employee to participate in the defined benefit plan nor the employee contributions made to the defined benefit plan are to be treated as elective deferrals for purposes of the annual limit. Similarly, if an employee is required to contribute a fixed percentage of compensation to a tax-sheltered annuity as a condition of employment, the contributions are not treated as elective deferrals. This is considered elective deferrals if the employer and employee enter into temporary employment contracts. The conferees do not intend these examples to constitute the only situations in which contributions are not treated as elective deferrals. The conferees direct the Secretary to provide guidance to employers on other contributions that are not to be treated as elective deferrals.

#### *Special catch-up election*

The conference agreement follows the House bill and extends the special catch-up election to employees of health and welfare service agencies.

#### *Effective dates*

The provisions are effective for taxable years beginning after December 31, 1986.

A special effective date applies to plans maintained pursuant to a collective bargaining agreement. Under this special rule, with respect to employees covered under a plan maintained pursuant to a collective bargaining agreement between employee representatives and one or more employers ratified before March 1, 1986, the amendments are not effective for plan years beginning before the earlier of (1) January 1, 1989, or (2) the date on which the last of the collective bargaining agreement[s] terminates (determined without regard to any extensions in the collective bargaining agreement).

*(ii) is treated as long-term capital gain under subsection (a)(2) of this section or section 403(a)(2).*

*(D) Vesting.—For purposes of this paragraph the term "vesting" means the portion of the accrued benefits derived from employer contributions to which the participant has a nonforfeitable right.*

**[CCH Explanation at ¶ 127, 670, 698, 709 and 718. Committee Report at ¶ 7104, 8108, 8122, 8852 and 8896.]**

(f) WRITTEN EXPLANATION TO RECIPIENTS OF DISTRIBUTIONS ELIGIBLE FOR ROLLOVER TREATMENT.—

(1) In General.—The plan administrator of any plan shall, when making a[n] *eligible rollover distribution*, provide a written explanation to the recipient—

* * *

*(2) Definitions.—For purposes of this subsection—*

*(A) Eligible Rollover Distribution.—The term "eligible rollover distribution" means any distribution any portion of which may be excluded from gross income under subsection (a)(5) of this section or subsection (a)(4) of section 403 if transferred to an eligible retirement plan in accordance with the requirements of such subsection.*

*(B) Eligible Retirement Plan.—The term "eligible retirement plan" has the meaning given such term by subsection (a)(5)(E)(iv).*

**[CCH Explanation at ¶ 724. Committee Report at ¶ 8898.]**

***→ Caution: Code Sec. 402(g), below, as added by Act Sec. 1852(b)(3)(A), is effective as if included in P.L. 98-369. ←***

*(g) TREATMENT OF SELF-EMPLOYED INDIVIDUALS.—For purposes of this section, except as otherwise provided in subparagraph (A) of subsection (e)(4), the term "employee" includes a self-employed individual (as defined in section 401(c)(1)(B)) and the employer of such individual shall be the person treated as his employer under section 401(c)(4).*

***→ Caution: Code Sec. 402(g), below, as added by Act Sec. 1854(f)(2), applies generally to any transaction occurring after 1984. ←***

*(g) EFFECT OF DISPOSITION OF STOCK BY PLAN ON NET UNREALIZED APPRECIATION.—*

*(1) In General.—For purposes of subsection (a)(1) or (e)(4)(J), in the case of any transaction to which this subsection applies, the determination of net unrealized appreciation shall be made without regard to such transaction.*

*(2) Transaction to Which Subsection Applies.—This subsection shall apply to any transaction in which—*

*(A) the plan trustee exchanges the plan's securities of the employer corporation for other such securities, or*

*(B) the plan trustee disposes of securities of the employer corporation and uses the proceeds of such disposition to acquire securities of the employer corporation within 90 days (or such longer period as the Secretary may prescribe), except that this subparagraph shall not apply to any employee with respect to whom a distribution of money was made during the period after such disposition and before such acquisition.*

***→ Caution: Code Sec. 402(g), below, as added by Act Sec. 1105(a), applies generally after 1986. ←***

*(g) LIMITATION ON EXCLUSION FOR ELECTIVE DEFERRALS.—*

*(1) In General.—Notwithstanding subsections (a)(8) and (h)(1)(B), the elective deferrals of any individual for any taxable year shall be included in such individual's gross income to the extent the amount of such deferrals for the taxable year exceeds $7,000.*

*(2) Required Distribution of Excess Deferrals.—*

*(A) In General.—If any amount (hereinafter in this paragraph referred to as "excess deferrals") is included in the gross income of an individual under paragraph (1) for any taxable year—*

*(i) not later than the 1st March 1 following the close of the taxable year, the individual may allocate the amount of such excess deferrals among the plans under which the deferrals were made and may notify each such plan of the portion allocated to it, and*

*(ii) not later than the 1st April 15 following the close of the taxable year, each such plan may distribute to the individual the amount allocated to it under clause (i) (and any income allocable to such amount).*

*The distribution described in clause (ii) may be made notwithstanding any other provision of law.*

*(B) Treatment of Distribution Under Section 401(k).—Except to the extent provided under rules prescribed by the Secretary, notwithstanding the distribution of any portion of an excess deferral from a plan under subparagraph (A)(ii), such portion shall, for purposes of applying section 401(k)(3)(A)(ii), be treated as an employer contribution.*

*(C) Taxation of Distribution.—In the case of a distribution to which subparagraph (A) applies—*

*(i) except as provided in clause (ii), such distribution shall not be included in gross income (and no tax shall be imposed under section 72(t)), and*

*(ii) any income on the excess deferral shall, for purposes of this chapter, be treated as earned and received in the taxable year in which such excess deferral is made.*

*(3) Elective Deferrals.—For purposes of this paragraph, the term "elective deferrals" means, with respect to any taxable year, the sum of—*

*(A) any employer contribution under a qualified cash or deferred arrangement (as defined in section 401(k)) to the extent not includible in gross income for the taxable year under subsection (a)(8) (determined without regard to this subsection),*

*(B) any employer contribution to the extent not includible in gross income for the taxable year under subsection (h)(1)(B) (determined without regard to this subsection), and*

*(C) any employer contribution to purchase an annuity contract under section 403(b) under a salary reduction agreement (within the meaning of section 3121(a)(5)(D)).*

*(4) Increase in Limit for Amounts Contributed Under Section 403(b) Contracts.—The limitation under paragraph (1) shall be increased (but not to an amount in excess of $9,500) by the amount of any employer contributions for the taxable year described in paragraph (3)(C).*

*(5) Cost-of-Living Adjustment.—The Secretary shall adjust the $7,000 amount under paragraph (1) at the same time and in the same manner as under section 415(d).*

*(6) Disregard of Community Property Laws.—This subsection shall be applied without regard to community property laws.*

*(7) Coordination with Section 72.—For purposes of applying section 72, any amount includible in gross income for any taxable year under this subsection but which is not distributed from the plan during such taxable year shall not be treated as investment in the contract.*

*(8) Special Rule for Certain Organizations.—*

*(A) In General.—In the case of a qualified employee of a qualified organization, with respect to employer contributions described in paragraph (3)(C) made by such organization, the limitation of paragraph (1) for any taxable year shall be increased by whichever of the following is the least:*

*(i) $3,000,*

*(ii) $15,000 reduced by amounts not included in gross income for prior taxable years by reason of this paragraph, or*

*(iii) the excess of $5,000 multiplied by the number of years of service of the employee with the qualified organization over the employer contributions described in paragraph (3) made by the organization on behalf of such employee for prior taxable years.*

*(B) Qualified Organization.—For purposes of this paragraph, the term "qualified organization" means any educational organization, hospital, home health service agency, health and welfare service agency, church, or convention or association of churches. Such term includes any organization described in section 414(e)(3)(B)(ii). Terms used in this subparagraph shall have the same meaning as when used in section 415(c)(4).*

*(C) Qualified Employee.—For purposes of this paragraph, the term "qualified employee" means any employee who has completed 15 years of service with the qualified organization.*

essary to ensure that employees have equal access to tax-sheltered annuities through salary reduction agreements.

### *Explanation of Provisions*

#### *Limit on elective deferrals*

The Act imposes a limit on elective deferrals under a tax-sheltered annuity which operates in the same manner as the limit on elective deferrals under a qualified cash or deferred arrangement. However, the annual limit on elective deferrals under a tax-sheltered annuity is $9,500 rather than $7,000. The $9,500 limit applies until the cost-of-living adjustments to the annual limit on elective deferrals under a qualified cash or deferred arrangement raise that limit from $7,000 to $9,500, at which time the limit on elective deferrals under a tax-sheltered annuity is also indexed in the same manner as the indexing of the annual limit for elective deferrals under a qualified cash or deferred arrangement.

Elective deferrals under a tax-sheltered annuity program consist of those employer contributions made pursuant to a salary reduction agreement, whether evidenced by a written instrument or otherwise (sec. 3121(a)(5)(D)), to the extent those contributions are excludable from the employee's gross income. If, however, an employee has a one-time election to participate in a program that requires a pre-tax contribution (or a post-tax employee contribution in lieu of a pre-tax contribution) as a condition of participation, such contribution will not be considered an elective deferral to the extent that the employee is not permitted subsequently to modify the election in any manner (including modifying the election to make post-tax contributions rather than pre-tax contributions). In addition, the Secretary is authorized to prescribe additional instances in which pre-tax contributions to a plan will not be considered elective despite the existence of limited rights of election by the employee.

If an employee has made more than 1 election, it is presumed that pre-tax contributions subject to the elections are elective deferrals. The presumption can only be rebutted by evidence demonstrating that a subsequent election was made following a bona fide separation from service, and not a temporary absence.

#### *Special catch-up election*

The Act provides an exception to the $9,500 annual limit (but not to the otherwise applicable exclusion allowance (sec. 403(b)) or the limit on contributions and benefits (sec. 415)) in the case of employees of an educational organization, a hospital, a home health service agency, a health and welfare service agency, a church, or a convention or association of churches. Under this exception, any eligible employee who had completed 15 years of service with the employer would be permitted to make an additional salary reduction contribution under the following conditions:

(1) In no year can the additional contributions be more than $3,000 (and, therefore, the $9,500 limit may not be increased above $12,500);

(2) An aggregate, lifetime limit of $15,000 applies to the total amount of catch-up contributions (i.e., contributions that, in any year, exceed the limit on elective deferrals for that year); and

(3) In no event can this exception be used if an individual's lifetime elective deferrals exceed the individual's lifetime limit.

The lifetime limit on elective deferrals for an individual, solely for purposes of the special catch-up rule, is $5,000 multiplied by the number of years of service (within the meaning of sec. 403(b))[36] that the individual performed with the employer.

Further, it is intended that the definition of years of service for purposes of the special catchup election will include principles similar to the principles of section 414(a). For this purpose, an employee's years of service will be determined by including all years of service with a predecessor employer (within the meaning of sec. 414(a)). Thus, years of service with a denomination of a church that merges into or combines with another denomination generally are to be aggregated with years of service with the surviving denomination.

Because employers may not have records for prior years with respect to the portion of contributions to tax-sheltered annuities that were elective deferrals, it may be difficult for employers to calculate the lifetime limit for an employee. It is expected that the Secretary will provide administrable methods that employers can use to calculate elective deferrals for prior years.

### *Effective Dates*

The provisions are effective for taxable years beginning after December 31, 1986. A special effective date applies to plans maintained pursuant to a collective bargaining agreement.

### *Revenue Effect*

This provision and the provisions discussed in 2., 3., and 4., of this Part A are estimated to increase fiscal year budget receipts by $310 million in 1987, $628 million in 1988, $691 million in 1989, $809 million in 1990, and $924 million in 1991.

## 7. Special rules for simplified employee pensions (sec. 1108 of the Act and sec. 408(k) of the Code)[37]

### *Prior Law*

Under prior and present law, if an IRA qualifies as a simplified employee pension (SEP), the annual IRA deduction limit is increased to the lesser of $30,000 or 15 percent of compensation. Under prior law, the increased deduction limit applied only to employer contributions made on behalf of an employee to the SEP on a nonelective basis.

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[36] A technical correction may be needed so that the statute reflects this intent.

[37] For legislative background of the provision, see: H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986, sec. 1208; S.Rep. 99-313, pp. 569-572; and H.Rep. 99-841, Vol. II (September 18, 1986), pp. 406-408 (Conference Report).

## Section 1107

## AMERICAN COUNCIL ON EDUCATION

BEFORE THE

COMMITTEE ON WAYS AND MEANS

U.S. HOUSE OF REPRESENTATIVES

ON BEHALF OF:

American Association of Community and Junior Colleges
American Association of State Colleges and Universities
Association of American Universities
Association of Catholic Colleges and Universities
Association of Jesuit Colleges and Universities
Association of Urban Universities
Council of Independent Colleges
National Association for Equal Opportunity in Higher Education
National Association of College and University Business Officers
National Association of Independent Colleges and Universities
National Association of Schools and Colleges of the United Methodist Church
National Association of State Universities and Land-Grant Colleges

On behalf of the American Council on Education, representing over 1,500 colleges and universities, and the associations listed on the cover sheet we wish to submit our comments on HR 2636, the Technical Corrections Act of 1987 as it relates to Section 457 of the Internal Revenue Code.

Section 1107 of the Tax Reform Act of 1986 extended Internal Revenue Code Section 457, which previously only applied to state and local governments, to certain deferred compensation plans of tax-exempt employers.

Although the 1986 Act expanded the group of employers subject to Section 457, there was no indication by Congress that the substantive scope of Section 457 had been changed. Nevertheless, the Internal Revenue Service has taken an initial public position that the types and nature of deferred compensation plans governed by Section 457 include nonelective deferred benefit plans (e.g., vacation pay plans, severance pay plans and nonelective retirement pay plans) which heretofore generally had been thought to be outside the scope of the Section 457 rules.

A clear statement through the Technical Corrections Act of 1987 (HR 2636) is required to negate the overbroad interpretation by the IRS and to reaffirm that Section 457 does not extend to nonelective deferred compensation of tax-exempt organizations and state and local government employers.

July 15, 1987

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Robert J. Leonard
Chief Counsel
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U.S. House of Representatives
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RE: Committee on Ways and Means Request for
Public Comment on H.R. 2636 Technical
Corrections Act of 1987

Dear Mr. Leonard:

In accordance with Ways and Means Committee Press Release #15, we are respectfully submitting comment on an apparent oversight concerning Act Section 1107 of TRA '86 and Section 457 of the Internal Revenue Code.

Act Section 1107 of TRA '86 extended for the first time unfunded deferred compensation plans described in IRC §457 to employees of nongovernmental tax-exempt organizations on supposedly the same basis as they are made available to employees of State and local governments. Nongovernmental tax-exempt organizations are defined at IRC §§501(c) and 501(d), and in total consist of some 25 different types of organizations ranging from credit unions to labor organizations.

However, the Department of Labor, in a release dated December 19, 1986, has indicated such is not the case (see U.S. Dept. of Labor News Release dated 19 December 1986 enclosed). In this Release, the Department of Labor has taken the position that plans described in IRC §457 maintained by nongovernmental tax-exempt organizations are only available for a "select group of management or highly compensated employees". This position is based on the premise that no Act Section exists under ERISA whereby plans maintained by nongovernmental tax-exempt organizations are excluded from the requirements of Title I of ERISA.

This position was further confirmed in a telephone conversation with Department of Labor representative, Linda Shore, 7 July 1984. As stated by her, Congressional action must be taken to specifically exclude IRC §457 plans maintained by nongovernmental tax-exempt organizations from the requirements of Title I of ERISA before such plans would be permissible. As indicated by her, such an exclusion does exist for governmental plans under §3(32) of Title I of ERISA; therefore, IRC §457 plans maintained by State or local governments can be offered to all employees in general and is not limited to only a "select group of management or highly compensated employees".

In the locale that we serve, we have numerous credit unions, labor organizations, etc., that are poised to offer such plans to all of their employees, but are now stymied by what appears to be conflicting positions being maintained by two branches of the government. Treasury, on the one hand stating it is permissible for nongovernmental tax-exempt organizations to sponsor IRC §457 plans; and Labor, on the other hand, stating not so until a specific exclusion is provided from Title I requirements of ERISA.

Therefore, we respectfully request that immediate attention be given to this area in the Technical Corrections Act as it pertains to Act §1107 of TRA '86. To deny nongovernmental tax-exempt organizations to maintain such plans simply because of a conflict between two regulatory agencies of the government would be a travesty; especially so, since TRA '86 now prohibits these same nongovernmental tax-exempt organizations from maintaining 401(k) plans.

Should you have any further questions concerning these comments, please contact the undersigned, or Gerry Tornow of my staff. Should you wish to contact Linda Shore of the Department of Labor, she may be reached at phone number 202-5232-8672.

Sincerely,

Jeffrey N. Cashman, President
IPC Pension Companies, Inc.

GAT/jh

### SUMMARY STATEMENT

UNFUNDED DEFERRED COMPENSATION ARRANGEMENTS OF STATE AND LOCAL GOVERNMENTS AND TAX EXEMPT EMPLOYERS.
(Section 111(e) of the TCA '87 bill, Section 1107 of the Reform Act, and Section 457 of the Internal Revenue Code)

(a) Application to tax-exempt employers: ERISA Coverage

### Present Law

State and local governments are permitted under Section 457 of the Internal Revenue Code to maintain eligible unfunded deferred compensation plans. Amounts of current compensation deferred on behalf of participants under these plans are excluded from their gross income until such time as the funds are paid or made available to them. Because Congress determined that unfunded deferred compensation plans should be available to employees of nongovernmental tax-exempt organizations on the same basis as they are made available to employees of the State and local governments, Act Section 1107 was enacted effective for taxable years beginning after 31 December, 1986. The Act applies the limitations and restrictions applicable to eligible unfunded deferred compensation plans of State and local governments to unfunded deferred compensation plans maintained by nongovernmental tax-exempt organizations.

Accordingly, these plans need not satisfy any of the requirements of Internal Revenue Code Section 401(a); but must satisfy all of the requirements of Internal Revenue Code Section 457.

However, Title I of ERISA, which mirrors many of the provisions of Internal Revenue Code Section 401(a), is applicable to unfunded deferred compensation plans. As such, certain participation and vesting, funding, and fiduciary responsibility provisions are applicable to Section 457 plans sponsored by nongovernmental tax-exempt organizations, unlike State and local government sponsored Section 457 plans, which have a specific statutory exclusion from the requirements of Title I of ERISA.

### Reason for Technical Correction Change

In the absence of a specific ERISA exclusions, Section 457 plans sponsored by nongovernmental tax-exempt organizations would be required to satisfy Title I or ERISA; and in so doing would fail to satisfy Internal Revenue Code Section 457 requirements.

### Action Needed to Correct

A specific ERISA exclusion must be granted to nongovernmental tax-exempt organizations sponsoring Section 457 plans identical to the exclusions currently granted to State and local governments which sponsor this same type of plan.

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## LABOR DEPARTMENT ISSUES VIEWS ON ERISA COVERAGE OF TAX-EXEMPT ORGANIZATIONS

DOL News Release (USDL: 86-527). December 19, 1986.

**Tax-exempt organizations: Unfunded deferred compensation plans: ERISA coverage. —Unfunded deferred compensation plans established by tax-exempt organizations under Code Sec. 457 following the Tax Reform Act of 1986 are not exempt from ERISA Title I provisions concerning vesting, funding and fiduciary responsibility.**

Certain employee benefit plans established by tax-exempt organizations following recent tax law changes ordinarily would be covered by the Employee Retirement Income Security Act (ERISA), the Labor Department warned today.

The department's Pension and Welfare Benefits Administration said it was referring to unfunded deferred compensation plans established by tax-exempt organizations under Section 457 of the Internal Revenue Code as amended by the Tax Reform Act of 1986.

Such plans ordinarily would be subject to the requirements of title I of ERISA, the Labor Department said.

State and local governments are permitted under the code to maintain eligible unfunded deferred compensation plans. Amounts of current compensation deferred on behalf of participants under these plans are excluded from their gross income until such time as the funds are paid or made available to them.

Under the Tax Reform Act of 1986, this treatment was extended to unfunded deferred compensation plans of other tax-exempt organizations.

In the absence of specific ERISA exclusions, unfunded deferred compensation plans would generally be considered pension plans subject to certain participation and vesting, funding, and fiduciary responsibility provisions of title I of ERISA.

However, ERISA excludes from the requirements of title I any employee benefit plan which is defined as a governmental plan under section 3(32) of title I. However, such exclusion does not extend to plans maintained by tax-exempt organizations.

The Labor Department said it is concerned that the employee benefit plan community may be broadly interpreting the 1986 amendment of section 457 of the code as excluding the unfunded deferred compensation plans of tax-exempt organizations from title I coverage.

Consequently, the department is expressing its view that unfunded plans maintained by entities which are not statutorily exempt from title I of ERISA are subject to all applicable provisions of title I.

However, the department noted that if a tax-exempt organization maintains an unfunded plan primarily for the purpose of providing deferred compensation for a "select group of management or highly compensated employees" within the contemplation of sections 201(2), 301(a)(3) and 401(a)(1) of ERISA, the plan may be exempt from certain of ERISA's provisions relating to participation and vesting, funding and fiduciary responsibility.

NRECA NATIONAL RURAL ELECTRIC COOPERATIVE ASSOCIATION
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TESTIMONY OF THE NATIONAL RURAL ELECTRIC COOPERATIVE ASSOCIATION ON H.R. 2636, THE TECHNICAL CORRECTIONS ACT OF 1987, BEFORE THE COMMITTEE ON WAYS AND MEANS

July 17, 1987

Mr. Chairman and members of the Committee, my name is Anthony C. Williams. I am the Director of the Retirement, Safety and Insurance Department of the National Rural Electric Cooperative Association (NRECA) and the Administrator of the various welfare and pension programs sponsored by NRECA for its members. NRECA is the national service organization of the approximately 1,000 rural electric service systems operating in 46 states. These systems bring central station electric service to approximately 25 million farm and rural individuals in 2,600 of our nation's 3,100 countries. Our various programs provide pension and welfare benefits to over 110,000 employees and their dependents in those localities.

I want to express our appreciation to the members of this Committee for their interest in and support of our recommendations for technical corrections to the Tax Reform Act of 1986. The changes we proposed in Section 401(k) and section 125, as included in H.R. 2636, resolve two technical issues directly affecting the operation of our plans. We are seriously concerned, however, with the way the correction to Section 401(k) is presently drafted and request your consideration of another definition of a "rural electric cooperative plan".

The Tax Reform Act of 1986 permitted rural electric cooperatives and their allied organizations to provide 401(k) Cash or Deferred Plans to their employees. Section 401(k)(7) provides that a "rural electric cooperative plan" is a defined contribution plan established and maintained by a rural electric cooperative (as defined in Section 457(d)(9)(B)) or a national association of such rural electric cooperatives. Because the Tax Reform Act of 1986 repealed the definition of rural electric cooperatives found in Section 457, I.R.C. Section 401(k)(7) does not have a correct cross reference to Section 457. Therefore, a technical amendment is needed to clarify that the definition of a rural electric cooperative is the same as in Section 457 of the Internal Revenue Code of 1954.

Section 111(e)(3) of H.R. 2636, the Technical Corrections Act of 1987, make changes to the definition of a "rural electric cooperative plan" that would eliminate its availability to many rural electric cooperatives. It was always intended, because of the relative small size of most rural electric cooperatives, that Section 401(k) plans would be available through a master plan administered by their national association, the National Rural Electric Cooperative Association (NRECA). This section of H.R. 2636, however, eliminated the words "or a national association of such rural electric cooperatives" from Section 401(k)(7)(B).

Accordingly, we recommend that the words "or a national association of such rural electric cooperatives" be retained in Section 401(k)(7) and that the words "of the Internal Revenue Code of 1954" be inserted after the words "Section 457(d)(9)(B)" in Section 401(k)(7).

Alternatively, we recommend that the following language be incorporated in place that contained in Section 111(e)(3) for purposes of defining a "rural electric cooperative plan" and that the words "or a national association of such rural electric cooperatives" be retained in Section 401(k)(7):

"(7) RURAL ELECTRIC COOPERATIVE PLAN. - For purposes of this subsection -

(A) IN GENERAL. - The term 'rural electric cooperative plan' means any pension plan -

(i) which is a defined contribution plan (as defined in section 414(i)),

(ii) which is established and maintained by a rural electric cooperative, and

(iii) whose participants are employed by a rural electric cooperative or by any organization at least 80 percent of whose members are rural electric cooperatives.

(B) RURAL ELECTRIC COOPERATIVE DEFINED. - For the purposes of subparagraph (A), the term 'rural electric cooperative' means -

(i) any organization exempt from tax under section 501(a) or described in section 401(k)(4)(B)(i) and engaged primarily in providing electric service, and

(ii) a national association described in section 501(c)(6) which is exempt from tax under section 501(a) and at least 80 percent of whose members are organizations described in clause (i)."

Once again, I wish to thank the Chairman and members of this Committee for their consideration of our concerns and comments.

# THE SECTION 457 TASK FORCE*

July 15, 1987

RE: Technical Corrections Act of 1987 (H.R. 2636); Need to Clarify the Scope of Internal Revenue Code Section 457 so as to Exclude Nonelective Deferred Benefits.

---

## I. *Background*.

Section 1107 of the Tax Reform Act of 1986 (the "1986 Act") broadens the coverage of section 457 of the Internal Revenue Code (the "Code"). As a result, certain deferred compensation plans of tax-exempt organizations (other than state and local governments which were subject to section 457 before the 1986 Act) are subject to new rules. Generally, amended section 457 applies to tax-exempt organizations for taxable years beginning after December 31, 1986, although many existing plans are grandfathered under some circumstances for existing employees.

Tax-exempt organizations have expressed concern regarding the treatment of nonelective, nonqualified retirement pay plans (and other nonelective, employer-provided deferred benefits) under section 457. Likewise, state and local government employers have expressed similar concerns over the public position only recently taken by the Internal Revenue Service ("IRS") in Notice 87-13 regarding the scope of section 457 as originally enacted in 1978. The IRS position overstates the intended scope of section 457. This overstatement, in many cases, would require employees to pay tax on deferred benefits which such employees *have no right* to receive currently (and may never receive).

To allay the foregoing concerns and to reverse the erroneous IRS position, it is necessary to clarify the intended scope of section 457 in the Technical Corrections Act of 1987 (H.R. 2636). The balance of this memorandum discusses Code section 457 in the context of its legislative history, and explains why the general scope of section 457 which was not changed by the 1986 Act, should remain limited to non-qualified, *elective* deferred benefit arrangements. Nonqualified, *nonelective* retirement pay plans (as well as other nonelective deferred benefit plans) of both tax-exempt and state and local government employers should remain unaffected by section 457 in accordance with clear Congresssional intent.

## II. *Inapplicability of Section 457 to Nonelective, Non-Qualified Deferred Benefit Plans*.

### A. *Deferred Compensation Rules Before 1978; Constructive Receipt Rule*.

Prior to 1978, nonqualified deferred compensation arrangements were subject to broad statutory guidelines and regulations. A cash-basis employee included deferred amounts in income when those amounts were "actually or constructively received." Treas. Reg. 1.446-1(c)(1)(i); *See also* I.R.C. 451; Treas. Reg. 1.451-2 (constructive receipt of income). IRS administrative rulings further defined the income recognition rules for various nonqualified deferred compensation arrangements. *See, e.g.*, Rev. Rul. 60-31, 1960-1 C.B. 174 (guidelines for applying rule of constructive receipt to deferred compensation arrangements), *modified*, Rev. Rul. 70-435, 1970-2 C.B. 100 (replacing one factual example). Under traditional constructive receipt principles, deferred amounts are not taxed currently unless they are "made available" to the taxpayer so that the taxpayer can *elect* to receive such amounts *currently*. *See, e.g.*, *Metcalfe v. Commissioner*, 43 T.C.M. (CCH) 1393, 1396 (1982).

### B. Proposed Regulation Section 1.61-16.

In 1978, the IRS published Proposed Regulation section 1.61-16 (the "Proposed Regulation"), which would have eliminated the ability of employees to defer compensation at their individual option. See 43 Fed. Reg. 4638 (Feb. 3, 1978). Specifically, the Proposed Regulation would have required all cash-basis taxpayers covered by elective, nonqualified deferred compensation arrangements to recognize deferred amounts as income in the taxable year such amounts otherwise would have been payable, rather than in the later taxable year when the deferred amounts actually were paid.

By its terms, however, the Proposed Regulation only affected those amounts deferred "at the taxpayer's individual option." Id. Thus, nonelective, nonqualified retirement plans that basically consisted of deferred commitments to pay benefits pursuant to a formula or schedule were not the target of the Proposed Regulation. Since the benefits under such plans were not attributable to amounts deferred "at the taxpayer's individual option," they would not have been covered by the Proposed Regulation. Thus, under established income recognition rules, employees would not be taxed on nonelective unfunded retirement benefits until payments actually were made.

The Proposed Regulation was designed primarily to eliminate elective deferral arrangements for state and local government employees (although, by its terms, it applied to elective deferral arrangements of all taxpayers). See, e.g., Fischer, Deferred Compensation: Born Again -- for Now, 37 N.Y.U. Inst. on Fed. Tax'n 28-1, 28-8 to 12 (1979) (discusses history of Prop. Reg. 1.61-16).

### C. Congressional Response to the Proposed Regulation.

Congressional response was swift. Sections 131 and 132 of the Revenue Act of 1978 (the "1978 Act") specifically addressed most elective deferred compensation arrangements jeopardized by the Proposed Regulation. See Public Law 95-600, 92 Stat. 2779-83 (Nov. 6, 1978), reprinted in 1978-3 C.B. 13-17; see also H.R. Rep. No. 1445, 95th Cong., 2d Sess. 52-53, reprinted in 1978-3 C.B. 226-27 (reasons for change); S. Rep. No. 1263, 95th Cong., 2d Sess. 65, reprinted in 1978-3 C.B. 363 (reasons for change); H.R. Rep. No. 1800, 95th Cong., 2d Sess. 65, reprinted in 1978-3 C.B. 538 (reasons for change).

Section 131 of the 1978 Act created Code section 457, which applied to State and local government deferred compensation plans. Section 132 of the 1978 Act rejected application of the Proposed Regulation to deferred compensation plans of private, taxable employers. In section 132(a) of the Act, Congress pronounced that the legal principles governing private deferred compensation plans would be those in effect on February 1, 1978 (two days before publication of the Proposed Regulation). Id. at 92 Stat. 2782-83, reprinted in 1978-3 C.B. 16-17.

### D. Statutory Language and 1978 Legislative History Behind Section 457.

Section 457, by its terms, contemplates elective deferrals. See I.R.C. 457(b)(4) (agreement or arrangement providing for deferral); Treas. Reg. 1.457-2(b), 2(g) (same). Within the context of section 457, the very concept of "deferred compensation" presupposes a right or option to receive economic benefits currently, which benefits are deferred by agreement.

The legislative history confirms without ambiguity that the limitations on "deferred compensation plans" of state and local governments were never intended to apply to nonqualified retirement pay plans which were unfunded and nonelective (*i.e.*, employer-provided retirement plans with no elective or salary-reduction features):

> The treatment provided by [section 457] for an ineligible State deferred compensation plan *extends only to plans which provide an option to defer compensation and is inapplicable to a State's regular retirement system (whether or not such plan is a tax-qualified plan) which does not provide such an option*.
>
> [H.R. Rep. No. 1445, 95th Cong. 2d Sess. 57, *reprinted in* 1978-3 C.B. 231 (emphasis added).]
>
> The tax treatment of participants in an ineligible State deferred compensation plan *does not extend to participants in the State's regular retirement plan (whether or not qualified under 401(a))*.
>
> [S. Rep. No. 1263, 95th Cong., 2d Sess. 70, *reprinted in* 1978-3 C.B. 368 (emphasis added).]

When discussing the effect of section 457 on tax revenues, both the House and Senate Reports affirmed that section 457 continued "the *existing tax treatment*" of deferred compensation plans "within certain limitations." *See* H.R. Rep. No. 1445 at 58, *reprinted in* 1978-3 C.B. 232; S. Rep. No. 1263 at 71, *reprinted in* 1978-3 C.B. 369.

Section 457 was a response to the Proposed Regulation which addressed only *elective* deferral arrangements which were the subject of that Regulation. Both the House and Senate Reports regarding section 457 consistently referred to elective or contractual deferral arrangements. Further, there is no discussion in the legislative history to indicate that unfunded welfare benefit plans (*e.g.*, sick pay or vacation pay plans, survivor benefit plans or severance pay arrangements) were ever intended to be subject to the "deferred compensation" rules of section 457.

In effect, sections 131 and 132 of the 1978 Act were designed to permit *elective* deferrals by State and local government employees within specified limitations and unlimited elective deferrals by other employees. The Congress thereby retreated from the position taken in the Proposed Regulation, which would have required current income recognition of *all* elective deferrals. No change had ever been suggested, either in the Proposed Regulation or in section 457, regarding the tax treatment of unfunded, *nonelective* deferred benefits (*e.g.*, regular retirement plans, welfare benefit plans or survivor benefit plans). Thus, section 457 was clearly intended to be a relief provision.

Two other provisions of the 1978 Act also dealt with employee elections and their effect on current taxable compensation. 1978 Act Sections 134 and 135 created Code sections 125 (cafeteria plans) and 401(k) (cash or deferred arrangements), respectively. *See* Public Law 95-600, 92 Stat 2783-87 (Nov. 6, 1978), *reprinted in* 1978-3 C.B. 17-21. Neither Code section 125 nor Code section 401(k) refers to section 457, but all three of those sections impose limitations on an employee's ability, by agreement or election, to avoid or defer taxation on certain forms of employee benefits. In fact, Code section 125 was coordinated indirectly with section 457, since "deferred compensation plans" were excluded from the general cafeteria plan provisions. See id. at 92 Stat. 2784 (Code section 125(d)(2)), reprinted in 1978-3 C.B. 18.

It has been suggested that the absence in section 457 of words like "elect" or "choose" (which are used in sections 125 and 401(k)) manifests that Congress did not intend to limit section 457 to elective deferred benefits. But section 457 consistently refers to "agreements" or "arrangements" by employees to defer compensation. A reference in section 457 to "elective" deferred compensation would have been redundant. Therefore, especially when read in light of its legislative history, it seems clear that section 457 should apply only to elective unfunded deferrals.

### E. Confusion Regarding the Scope of Section 457.

Despite clear indications that section 457 applied only to elective deferrals (e.g., salary reduction arrangements), the elective/nonelective distinction was either ignored or forgotten in some instances.

One of the first sources of confusion is the Joint Committee's General Explanation of the Revenue Act of 1978 (the "1978 Blue Book"). The 1978 Blue Book accurately summarizes the history behind section 457 and the reasons Congress chose to limit deferred compensation arrangements for State and local government employees, citing the concern over "plans involving an individual election to defer compensation." See id. at 68. But the 1978 Blue Book's "Explanation of Provision" contains the following statement about section 457:

> The rules prescribed by the Act apply whether or not exployees [sic] and independent contractors are provided with an individual option to defer. [Id.]

While it is not clear with respect to what the above-quoted language has reference, it cannot be interpreted to mean that nonelective deferred benefits are subject to section 457 without being in direct conflict with the legislative history of the 1978 Act with respect to section 457.

A few years later, apparently due to some uncertainty as to the IRS's position regarding the application of section 457 to unfunded retirement plans, a provision which explicitly exempted certain nonelective judicial retirement plans from the section 457 rules was incorporated into the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA"). See TEFRA section 252, retroactively amending section 131(c) of the 1978 Act (enabling provisions of Code section 457). Although such nonelective plans should not have been affected by section 457 in any event, the Texas state judges sought to secure an ironclad statutory exemption and succeeded.

The "Reasons for Change" in the Senate Report confirmed that the contribution limits and rules of Code section 457 should not be applied to State judges' unfunded "defined benefit" retirement plans which had no elective features:

> Because the participant's benefit under such a [retirement] plan generally does not depend upon the participant's account balance, the committee believes it is inappropriate to apply contribution limits or other rules designed for defined contribution plans.
>
> [S. Rep. No. 494, 97th Cong., 2d Sess. 328 (1982).]

Unfortunately, the Senate Report suggested a defined-contribution/defined-benefit distinction as the line of demarcation for "appropriate" application of section 457. The elective/nonelective distinction was temporarily submerged.

Shortly after TEFRA was enacted, the Department of Treasury ("Treasury") issued final Regulations for Code section 457. While the Regulations themselves did not explicitly address the elective/nonelective issue, the preamble to those Regulations contained the following statement:

> [I]n the absence of statutory authority to provide for the exclusion of [unfunded regular retirement] plans from section 457(e)(1) and without clearer legislative guidance as to what form this exclusion should take, it has been decided that it is inappropriate to provide for this exclusion through regulations. Consequently, deferrals under an unfunded regular retirement plan of a State will be considered to be made under an ineligible plan, and not excludible from income under section 457(a).
>
> [47 Fed. Reg. 42336 (Sept. 27, 1982).]

Ignoring the ample legislative history indicating that nonelective, unfunded retirement plans are outside the ambit of section 457, Treasury suggested that all unfunded deferred benefit plans (except those specifically enumerated in section 457(e)(1)) had been swept away under the guise of section 457. Apparently, Treasury was unwilling to make an elective/nonelective distinction notwithstanding the presence of legislative history which indicated that section 457 was intended to apply only to elective deferral arrangements. No attempt was made to incorporate this provision into the regulations, evidencing apparent uncertainty on the part of the Treasury with respect to its own position.

### F. The 1986 Act.

The 1986 Act originated from The President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity (May 1985)("President's Proposal"). The President's Proposals included the proposed extension of section 457 to all tax-exempt employers. As described in the President's Proposals, the change in section 457 would affect elective deferrals by employees:

> The rules permitting the elective deferral of compensation by employees of States on a nonqualified and unfunded basis would be expanded to apply to the employees of employers exempt from tax under the Internal Revenue Code. Thus, an employee of a tax-exempt employer would be permitted to defer, on an elective basis and subject to the same limitations currently applicable to State employees a portion of his or her current compensation under a nonqualified and unfunded arrangement maintained by the employer (an "eligible deferred compensation plan"). Compensation deferred by an employee of a State or tax-exempt employer under an ineligible deferred compensation plan would be includible in the employee's gross income when there is no longer a substantial risk of forfeiture.
>
> [President's Proposal, Chapter 14.10 at 381 (emphasis added).]

There is no indication that Code section 457, as then in effect, was understood to apply to anything but elective deferral arrangements. In fact, the tenor of Treasury's description of the changes suggests that the employees of the tax-exempt community would be receiving a benefit from the extension of section 457, a suggestion clearly inconsistent with an extension of section 457 to nonelective deferred compensation.

Generally adopting the President's Proposals, the 1986 Act extended section 457 rules to tax-exempt employers. 1986 Act section 1107, H.R. Rep. No. 841, 99th Cong., 2d Sess. at I-361 to 366. The operative language of section 457 remained substantially the same, except for the deferral coordination rules of section 457(c) and the new distribution rules of section 457(d).

The Conference Report accompanying the 1986 Act gives no indication of any Congressional intent to expand the scope or nature of plans encompassed by section 457. See id. at II-397 to 400. And the Joint Committee's General Explanation of the Tax Reform Act of 1986 (the "1986 Blue Book"; published May 4, 1987) confirms that section 457 "continues to apply to the same types of deferred compensation to which it applied under prior law." Id. at 654. Thus, although the 1986 Act expanded the group of employers affected by section 457, it did not change the type or nature of deferred compensation plans subject to the section 457 rules.

The same types of nonelective, unfunded retirement plans maintained by state or local governments which always were beyond the intended scope of section 457 similarly should remain beyond the scope of amended section 457 as it applies to such plans maintained by tax-exempt organizations. For example, nonqualified, nonelective retirement pay plans with no salary reduction features should remain unaffected by section 457, whether they are maintained by governmental entities or tax-exempt organizations.

## III. Notice 87-13 and Examples of Plans to which Section 457 Should Not Apply.

On January 5, 1987, the IRS released Notice 87-13 (published January 26, 1987 in Internal Revenue Bulletin No. 1987-4), which contained the preliminary IRS views regarding the scope and application of Code section 457. At Q&A-26, the IRS adopted the following position:

> Section 457 applies to amounts deferred under a deferred compensation plan regardless of whether the plan is in the nature of an individual account or defined contribution plan or a defined benefit plan, including a deferred compensation plan that provides benefits in excess of the benefits provided under a qualified plan under section 401(a), a deferred compensation plan that provides benefits in excess of the benefits permitted to be provided under a qualified plan on account of section 415, and a deferred compensation plan that provides benefits only to a select a group of executives or other highly compensated employees (e.g., a "top hat" plan). Also, section 457 applies to amounts deferred even though deferred amounts are determined by reference to factors other than the annual compensation of the individual (e.g., years of service, final average salary), uncertain in aggregate amount, and are payable over an indeterminable period (e.g., over the life of the individual).

> Section 457 applies to amounts deferred under a deferred compensation plan, whether or not such deferral is pursuant to the election of the individual taxpayer. Thus, section 457 applies to both elective and nonelective deferred compensation amounts. [1987-4 I.R.B. at 26.]

The extreme position adopted by the IRS disregards the historical distinction between the tax treatment of employee elective deferrals and employer-provided, nonelective deferred benefits.

The IRS position threatens many unfunded retirement programs and other benefit programs (*e.g.*, vacation pay and sick pay plans) maintained by tax-exempt organizations and State and local governments. It is understood that some State and local government employees participate in both (i) an "eligible deferred compensation plan" under section 457 (which generally permits elective deferrals up to $7,500 per year), and (ii) a nonelective unfunded retirement plan which provides an annuity form of retirement benefit based upon years of service and final average compensation. The IRS apparently intends to treat such retirement plans as "ineligible" plans subject to section 457. Such an interpretation could result in the retroactive taxation of benefits "accrued" under such retirement plans since as far back as 1978.

Section 457 contemplates agreements by employees with employers whereby limited elective deferrals may be made with favored tax treatment. Thus, section 457 should properly be interpreted to affect only unfunded salary reduction agreements whereby an employee elects to forego current compensation in exchange for unfunded future payments.

## IV. Revenue Impact and Administrative Concerns

State and local governments have administered elective deferred benefit plans under section 457 since 1978. Under the 1986 Act, the same rules limiting elective deferrals will apply to tax-exempt employers. The suggested legislative clarification would explicitly exclude nonelective deferral arrangements from the section 457 rules. Since such nonelective arrangements never were intended to provide revenue under section 457, their continued exclusion should have no adverse impact on projected tax revenues.

On the other hand, the unwarranted interpretation of section 457 adopted by the IRS would result in current taxation of nonelective deferred benefits. Employees of both tax-exempt organizations and state and local governments would have to recognize as current income the "present value" of hypothetical deferred benefit "accruals." The accurate valuation of these accruals would be virtually impossible in many cases. If the employee did forfeit benefits or if the employer became insolvent before the nonelective deferred benefits were paid, such employees would have paid tax on income never received and with respect to "benefits" over which they had no control or right to demand current payment. Such treatment would be totally at odds with the entire history of the Federal individual income tax system under which individual taxpayers are taxed on the cash basis method of accounting.

Affected employers would confront administrative nightmares coordinating elective and nonelective deferred benefit plans if both involuntary "accruals" and elective employee deferrals were subject to section 457 limits. Further, employees would perceive the current taxation of deferred income over which they have no control as grossly unfair.

In light of the IRS pronouncement in Notice 87-13, the Congress should now take the opportunity to clearly state that section 457 does not apply to nonelective deferred compensation. As a part of that process, the distinction between elective and nonelective deferrals also could be clarified, most easily through illustrations and examples made part of the legislative history. The Section 457 Task Force is prepared to work with the Ways and Means Committee to assist in any way with this effort.

## THE SECTION 457 TASK FORCE*

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July 14, 1987

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Re: Section 457 Task Force - Technical Corrections Act of 1987

Dear Mr. Kies:

Representatives of the Church Alliance have reviewed the materials that you will be forwarding to the Ways & Means Committee on behalf of the Section 457 Task Force, and we are in hearty agreement with the relief that you are requesting therein. The Church Alliance has submitted its own comments on the section 457 issue, and the Church Alliance also submits that section 457 has never covered, and should not cover, nonelective deferred compensation arrangements.

We in the Church Alliance look forward to working closely with you and the other members of the Section 457 Task Force to make sure that nonelective deferred compensation arrangements are preserved for the 28 mainline denominations represented through the Church Alliance.

Sincerely yours,

Gary S Nash

Gary S. Nash,
Church Alliance Secretary

## Section 1108

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July 9, 1987

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Re: Technical Corrections Bill of 1987 (H. R. 2636)

Dear Mr. Leonard:

Please consider the following comment with respect to the Technical Corrections Bill of 1987:

Description of Provision

Code §408(k)(3)(B), following amendment of subparagraph (A) by Section 1108(g)(1)(A) of the Tax Reform Act of 1986.

Problem

Clause (ii) of subparagraph (B), providing a rule for determining when an individual is considered a shareholder, pertains to prior law which was superseded by the definition of "highly compensated employee" in Section 414(q).

Solution

Delete clause (ii). To do this, a new paragraph should be added to §111(f) of the Technical Corrections Bill to read as follows:

"Subparagraph (B) of Section 408(k)(3) of the 1986 Code (relating to prohibited discrimination) is amended to read as follows:

"(B) SPECIAL RULE.-For purposes of subparagraph (A) there shall be excluded from consideration employees described in subparagraph (A) or (C) of Section 410(b)(3)."

If further discussion related to this comment is desired, please contact the undersigned.

Respectfully submitted,

Patrick J. Foley

Patrick J. Foley

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July 10, 1987

The Honorable Dan Rostenkowski, Chairman
Committee on Ways and Means
1102 LHOB
Washington, D.C. 20515

Dear Chairman Rostenkowski:

We are writing to comment on Sections 111(f)(1)(a)(ii) and (2) and Section 111(f)(7)(2) of the proposed Technical Corrections Act of 1987 (H.R. 2636). These sections would eliminate important substantive protections that are now provided by the Tax Reform Act of 1986 to workers covered by Simplified Employee Pensions. They would significantly expand the number of companies able to offer salary reduction SEPs and would delay the effective date of the SEP integration rules. We oppose these changes. They are not "technical" and they represent unsound tax and retirement policies inconsistent with the pension equity objectives of the Tax Reform Act.

I. Section 1108(a) of the Tax Reform Act permits employers with 25 or fewer employees to offer a salary deferral arrangement as part of a Simplified Employee Pension plan. Sections 111(f)(1)(a)(ii) and (2) of the Technical Corrections Act would make salary reduction SEPs available to companies with 25 employees who "are eligible to participate" in the SEP.

Employers are permitted to exclude the following categories of employees from SEPs:

- employees who have not worked for the company during 3 out of the last 5 years;
- employees who earn less than $300 a year;
- employees who have not reached age 21;
- employees covered by a collective bargaining agreement, if retirement benefits were the subject of good faith bargaining; and
- non-resident aliens.

The proposed change would, accordingly, permit employers of any size to offer a salary deferral SEP as long as only 25 employees were eligible to participate in the SEP. For example, an employer with 100 employees could offer a salary deferral SEP as long as 75 of the employees had fewer than three years of service or were represented by a union.

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This was not what Congress intended in adopting Section 1108(a). Members of Congress had heard testimony that only 14 percent of workers in companies with fewer than 25 employees are covered by retirement plans and that small businesses were often deterred by high administrative costs from setting up 401(k) plans. The salary deferral provision included in the law was carefully targeted to provide a simplified tax deferred savings vehicle for these very small companies. There was no intention that it apply to larger employers that can easily afford the administrative costs of a 401(k) plan as a trade-off for the very generous tax shelter that 401(k)s provide for themselves and their middle income and high-paid employees.

Permitting companies with more than 25 employees to offer salary reduction features in their SEPs would undercut the retirement security of workers who might otherwise benefit from these plans. The availability of a salary deferral feature encourages companies to set up SEPs funded entirely by voluntary savings rather than employer contributions. This means that lower-paid employees who cannot afford to save for themselves will receive no benefits from these plans. It also invites tax abuse since SEPs are free of the reporting obligations that permit the government to test for nondiscrimination (and have to cover only 50% rather than 70% of employees).

II. The Tax Reform Act limits the amount of social security that employers can take into account when contributing to SEPs. Starting in 1987, employers contributing to a SEP are required to make contributions for all eligible employees. No longer can they contribute only for employees earning more than $43,800, the social security wage base. Also under current law, the percentage of pay contributed on earnings over the wage base cannot be more than twice the percentage of pay contributed for earnings below the wage base.

The decision to make these new integration rules effective immediately for SEPs reflects the fact that SEP contributions are determined on a year-to-year basis. Unlike other plans where plan documents depend on a fixed formula or require the contribution of a set percentage of pay or profits, an employer maintaining a SEP chooses each year how much to contribute--or whether to contribute at all. There is no need to amend plan documents or revise pre-determined funding schedules to bring SEPs into compliance with the new integration rules.

The fact that the IRS has not issued regulations for the new SEP integration rules is no justification for denying lower-paid workers much needed benefits for an additional two years. The requirements of the law as applied to SEPs are straightfoward, and can easily be implemented in the absence of IRS interpretation. Should there be ambiguities, they can readily be resolved. Virtually all non-Model SEPs are issued by financial institutions that can request IRS rulings to assure that their plans are in compliance with the new law.

The 1987 effective date for the new SEP integration rules reflects a deliberate policy change designed to afford important protections to the growing number of workers covered by SEPs. We trust you will not do away with those protections under the guise of technical corrections.

Sincerely yours,

Amy Shannon

Amy R. Shannon
SEP Campaign Coordinator

## Section 1112

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July 2, 1987

Mr. Robert J. Leonard
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RE: Comments on the Technical Corrections Act of 1987

Dear Mr. Leonard:

Pursuant to the recent press release issued by House, Ways and Means Committee Chairman Dan Rostenkowski, we are taking this opportunity to bring to your attention a serious threat to the tax qualification of retirement plans maintained by governmental entities under new Section 401(a)(26) which was added to the Code by the Tax Reform Act of 1986.

As you are undoubtedly aware, new Section 401(a)(26) sets forth a new rule, effective for the first plan year beginning in 1989, which provides that a trust shall not constitute a qualified trust under Section 401(a) of the Code unless such trust is a part of a plan which, on each day of the plan year, benefits the lesser of: (i) 50 employees of the employer; or (ii) 40 percent or more of all employees of the employer.

Section 401(a) was not amended to exempt governmental plans from the requirements of Section 401(a)(26).

In the course of my general representation of municipalities and other local governments in connection with their employee benefit programs, I am aware that many governmental units sponsor more than one qualified plan for employees. In many cases, the sponsorship of multiple plans is required by statute. For example, in the State of Nebraska cities of the first class are required to sponsor separate retirement systems for its police officers and firefighters. In addition, most cities sponsor a qualified retirement plan for employees who are not police officers or firefighters. As a result, the typical city would maintain at least three separate and distinct plans, two of which are mandated by state statute. We understand that the sponsorship of separate benefit plans for distinct classes of employees of state and local governments is quite common throughout the country.

In most cases, all plans maintained by the governmental entity are qualified under Section 401(a). However, in many cases, none of the plans would have 50 employees who are participating in the plan. Therefore, when new Section 401(a)(26) becomes effective, one or more of the plans would become automatically disqualified.

This result can be illustrated as follows. Assume that a city which is required to maintain three separate plans has 30 employees participating in each plan. Since none of the plans has 50 participants, it must meet the 40 percent test of new Section 401(a)(26) to maintain qualified status. However, each plan only covers 33 1/3 percent of the total workforce. As a result, all three plans would be disqualified. In a private employer setting, the practical response to Section 401(a)(26) would be to merge two or more of the sponsored plans to satisfy the requirements of new Section 401(a)(26). However, such merger of governmental plans is not possible where the plans are mandated by statute and cannot be merged without legislative approval. Such approval would be politically impossible in many cases.

It would seem that relief from this harsh result should be provided in the Technical Corrections Bill now being considered by Congress. We cannot believe that Congress intended to disqualify a vast number of government plans when new Section 401(a)(26) was adopted.

In support of this request, we note that the discrimination concerns which prompted the adoption of new Section 401(a)(26) are not present under plans sponsored by a governmental entity. The political and fiscal constraints upon state and local governments generally make it impossible to implement a benefit plan which intentionally discriminates in favor of highly compensated individuals. Furthermore, it would be consistent with the overall intent of ERISA and Internal Revenue Code to continue to exempt governmental plans from this type of regulation. It does not make sense for such plans to be exempt from the general nondiscrimination requirements of Section 410 of the Code while making such governmental plans subject to the minimum participation requirements of new Section 401(a)(26).

The proposed amendments to Section 401(a)(26) under the Technical Corrections Act would not appear to provide any relief from the adverse results outlined in this letter. For example, it would not be possible to transfer coverage of a highly compensated police officer to a plan maintained for the other city employees since such transfer would, in many cases, violate the statutes governing the plan for the police officers.

For these reasons, we ask that the House, Ways and Means Committee give serious consideration in the pending Technical Corrections Bill to exempting governmental plans from the coverage of new Section 401(a)(26).

We do offer our continuing assistance in this matter should you have any questions or require additional information regarding the impact of new Section 401(a)(26) upon governmental plans.

Very truly yours,

Gary N Clatterbuck

Gary N. Clatterbuck
FOR THE FIRM

## Section 1114

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July 13, 1987

HAND DELIVERED

Robert Leonard, Esquire
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1102 Longworth House Office Building
Washington, D.C. 20515

Dear Mr. Leonard:

This is in response to the request for comments on H.R. 2636, The Technical Corrections Act of 1987. These comments are submitted on behalf of James J. Albertine, Director of Government Affairs, American Society of Association Executives ("ASAE"). A brief biographical statement concerning ASAE is enclosed for your information. ASAE seeks to modify the definitions of highly compensated employee and key employee in the Internal Revenue Code ("Code") to include a cost of living adjustment to the current dollar amount in the officer portion of the definitions based on the adjustment under Section 415(d) of the Code.

### Background

The Tax Reform Act of 1986 included a definition of "highly compensated employee" in Section 414(q) of the Code to be used for numerous tax-qualified pension plan purposes. The officer component is the primary component of the highly compensated employee definition that applies to the members represented by ASAE. A highly compensated employee is defined as an employee who, at any time during the current year or the preceding year (a) was a 5% owner, (b) received more than $75,000 in annual compensation, (c) received more than $50,000 in annual compensation and was a member of the top 20% of employees ranked by compensation (the "top-paid group"), and (d) was an officer and received more than $45,000 (150% times the maximum dollar limit on Annual Additions for defined contribution plans).

Section 111(j)(1) of H.R. 2636 would amend the definition of "highly compensated employee" in Section 414(q) of the Code to adjust the $75,000 and $50,000 amounts for cost of living adjustments made under Section 415(d) to the dollar limit applicable to defined benefit plans. Section 111(j)(1), as written, does not contain a similar cost of living adjustment to the $45,000 amount.

Section 416 of the Code contains a definition of "key employee" for purposes of the top-heavy rules. That definition includes an officer earning more than $45,000 (150% of the dollar limitation on Annual Additions for a defined contribution plan). Thus, the officer component of the key employee definition is identical to the officer component of the highly compensated employee definition. H.R. 2636 does not contain any provision relating to the definition of "key employee".

### ASAE's Position

ASAE believes that the dollar amount in the officer component of the highly compensated employee definition should be subject to cost of living adjustments at the same time and in the same manner as the adjustments to the $75,000 and

$50,000 dollar amounts in that definition. The Description of the Technical Corrections Act of 1987 prepared by the staff of the Joint Committee on Taxation, dated June 15, 1987, states at page 112 that the reason for the adjustment to the $75,000 and $50,000 amounts is "to prevent the definition of 'highly compensated employee' from becoming inappropriate by virtue of inflation." In ASAE's view, the same logic applies to the dollar amount in the officer component of the highly compensated employee definition.

The dollar amount in the officer component of the highly compensated employee definition is equal to 150% of the dollar limit on Annual Additions to a defined contribution plan under Section 415(c)(1)(A). The dollar limit under Section 415(c)(1)(A) is $30,000 or, if greater, 1/4 of the dollar limitation applicable to defined benefit plans under Section 415(b)(1)(A). The defined benefit plan dollar limitation under Section 415(b)(1)(A) is currently $90,000. This limit is scheduled to be adjusted under Section 415(d) of the Code in 1988. The dollar limit on Annual Additions will not be adjusted until the defined benefit plan dollar limitation exceeds $120,000. Based on the recent rate of inflation, it is unlikely that the defined benefit plan dollar limitation will increase from $90,000 to more than $120,000 in the next several years.

The adjustments to the $75,000 and $50,000 amounts in the definition of highly compensated employee are based on the adjustments to the defined plan dollar limitation. Therefore, the $75,000 and $50,000 amounts will be adjusted for inflation as early as 1988. The dollar amount in the officer component of the definition of highly compensated employee is based on the adjustment to the defined contribution plan dollar limitation. Because the defined contribution plan dollar limitation is unlikely to increase for a number of years, the dollar amount in the officer component of the definition of highly compensated employee is unlikely to increase for a number of years.

ASAE believes that the same sound policy reasons that dictate an adjustment to the $75,000 and $50,000 amounts "to prevent the definition of 'highly compensated employee' from becoming inappropriate by virtue of inflation" also apply to the dollar amount in the officer component of the definition of highly compensated employee. Further, the adjustment to the dollar amount in the officer component should be made at the same time and in the same manner as the adjustment to the $75,000 and $50,000 amount. This can be accomplished in H.R. 2636 by changing the officer component of the highly compensated employee definition in Section 414(q)(1)(D) of the Code to reference the current $45,000 amount in effect, and by modifying Section 111(j) of H.R. 2636 to amend Section 414(q)(1) of the Code to authorize the Secretary of Treasury to adjust the $75,000, $50,000 and $45,000 amounts at the same time and in the same manner as under Section 415(d) of the Code.

The officer component of the highly compensated employee definition appears to be based on the officer component of the key employee definition. The key employee definition does not include any specific cost of living adjustments. However, the reference in the officer definition to the dollar limitation in Section 415(c)(1)(A) was evidently intended to provide for an automatic cost of living adjustment. Because the Tax Reform Act of 1986 changes Section 415(c)(1)(A) to freeze the dollar amount indefinitely, an increase in the dollar amount in the officer component of the key employee definition in the near future is unlikely. ASAE believes that the dollar amount in the officer component of the highly compensated employee definition should be modified to be subject to cost of living adjustments to avoid the key employee definition from becoming inappropriate because of inflation, (Even though the overwhelming majority of ASAE members do not work for employers with owners, the same logic would apply to other components of the key employee definition that include or reference a dollar amount.) This can be accomplished in H.R. 2636 by amending the officer component of the key employee definition in Section 416(i)(1)A)(i) to reference the current $45,000 amount in effect and by amending Section 416(i)(1) of the Code to authorize the Secretary of Treasury to adjust the $45,000 amount at the same time and in the same manner as under Section 415(d) of the Code.

## Requested Relief

ASAE requests that Congress provide in H.R. 2636 for a change in the officer component of the definition of "highly compensated employee" in Section 414(q) of the Code and a change in the officer component of the definition of "key employee" in Section 416(i) of the Code. These changes would specify that the applicable dollar amount is currently $45,000, and would provide that this amount is to be adjusted annually at the same time and in the same manner as the adjustment under Section 415(d) of the Code to the defined benefit plan dollar limitation.

ASAE appreciates the opportunity to present its views on this important issue. We would welcome the opportunity, should you find it helpful, to schedule a meeting with me and a representative or representatives from ASAE to discuss this issue in greater detail.

Sincerely,

SANDERS, SCHNABEL & BRANDENBURG, P.C.

Dan S. Brandenburg

## BIOGRAPHICAL STATEMENT

## ON THE AMERICAN SOCIETY OF ASSOCIATION EXECUTIVES

ASAE is headquartered at 1575 Eye Street, N.W., Washington, D.C. 20005 (202-626-2703) and is the professional society for executives who manage trade and professional associations as well as other not-for-profit voluntary organizations in the United States and abroad. Founded in 1920 as the American Trade Association Executives with 67 charter members, ASAE now has a membership of nearly 14,000 individuals representing more than 7,500 national, state, and local associations. The overwhelming majority of ASAE's members represent tax-exempt organizations, most of which are either tax-exempt as trade associations under Section 501(c)(6) of the Internal Revenue Code ("Code") or tax exempt as educational or charitable organizations under Section 501(c)(3) of the Code. Many of ASAE's member associations either sponsor or are contemplating sponsoring funded welfare benefit plans.

ROBERT T. MATSUI
THIRD DISTRICT, CALIFORNIA

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July 10,1987

The Honorable Dan Rostenkowski
Chairman, Committee on Ways and Means
1100 Longworth House Office Building
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Dear Mr. Chairman:

This responds to your request for suggestions for additional technical corrections. Section 414(m), Miscellaneous Revenue Act of 1980, was added to prevent abuse of certain pension plan provisions through the use of separate corporations or other organizations. These professionals were incorporating their existing partnerships to continue their practice in partnership form. The physicians derived substanially all of their income from the incorporated partnership. Section 414(m) expanded the classes of controlled groups of employers which are treated as a single employer in testing whether a pension plan, cafeteria or medical reimbursement plan, or a simplified employee pension plan meets the nondiscrimination standards and other requirements of the tax law for favorable treatment. It was designed to prohibit the use of separate entities in an attempt requirements designed to benefit rank-in-file employees.

The problem with Section 414(m) however, is that its scope is too broad. The definition of affiliated service groups covers more groups than the physicians who incorporated their partnerships. It includes such ventures as hospital-physician joint ventures, and to some hospital-hospital joint ventures which are primarily investment vechicles for hospitals and professionals to improve the health care system in their community and not to circumvent the intent of the pension law provisions protecting rank-in-file employees from unfair treatment. The uncertainty of the application of Section 414(m) may chill the development of innovative and needed ventures providing essential health care delivery systems.

Enclosed for your convenience is some additional background material. Your consideration of this issue is greatly appreciated.

Very Truly Yours,

Bob

ROBERT T. MATSUI
Member of Congress

## POSITION PAPER -- SUGGESTED CHANGES TO SECTION 414(m) OF THE INTERNAL REVENUE CODE TO FACILITATE PHYSICIAN-HOSPITAL AND PHYSICIAN-PHYSICIAN JOINT VENTURES

### Background

Section 414(m) of the Internal Revenue Code was added in 1980 as part of the Miscellaneous Revenue Act of 1980. It was added to prevent abuse of certain pension plan provisions through the use of separate corporations or other organizations. Physicians, and other professionals using professional corporations, were considered the primary abusers. These professionals were incorporating their existing partnerships to continue their practice in partnership form. The physicians derived substantially all of their income from the incorporated partnership. (See attached Exhibits 1 through 7.) The new provision expanded the classes of controlled groups of employers which are treated as a single employer in testing whether a pension plan, cafeteria or medical reimbursement plan, or a simplified employee pension plan meets the nondiscrimination standards and other requirements of the tax law for favorable tax treatment. It was designed to prohibit the use of separate entities in an attempt to avoid employee benefit requirements designed to benefit rank-and-file employees.

## Problems

The main problem with section 414(m) is its scope considering the evolution of health care delivery systems in the United States since the section's enactment. Its definition of affiliated service groups covers more groups than the physicians who incorporated their partnerships and is simply too broad. Literal enforcement of this provision would have a chilling effect on the progress of modernizing the health care system to the American people. This problem can best be seen by the use of examples which are common in the modern health care system.

### 1. IPAs

Independent Practice Associations ("IPA") are usually professional corporations which contract with Health Maintenance Organizations ("HMO") to provide professional services to health plan members. Physician shareholders in the IPA normally only receive a small fraction of their total income from their interest in the IPA. Physicians normally maintain their own independent offices and their own employees. The IPA may have one or two employees or it may contract with a third party for all services. Regardless, section 414(m) would treat all employees of all of the physicians as members of an affiliated service group and thus as employees of a single employer. The outcome of such a treatment might very well lead to the disqualification of each of the physicians' plans.

There are hundreds of IPAs throughout the country which fit this example. IPAs were not organized to avoid the cost of providing benefits for rank-and-file employees. Indeed, they were formed to participate in federally qualified HMOs. Nevertheless, the scope of 414(m) is broad enough to threaten the participants' pension plans.

### 2. Hospital-Physician Joint Ventures

The development of hospital-physician joint ventures has been an important factor to update and provide the latest medical technology to, and expand medical services in, communities throughout the country. The joint ventures, usually limited partnerships, have been formed to build and operate physician office buildings, imaging centers, outpatient surgery centers and cancer treatment centers. Most of the participants are limited partners, some are general partners. Under many, if not all, of these arrangements the participants will be treated under section 414(m) as an affiliated service group and as if their employees are all employed by a single employer for purposes of nondiscrimination standards. The limited partners are passive investors. The limited partners may occasionally or regularly refer their patients to the partnership for diagnostic or medical treatment. The percentage of patients referred may be quite small. Income from such ventures is not substantial in relationship to the limited partners' total income.

### 3. Summary of Problem

The literal application of section 414(m)'s language covers groups that the statute was not originally contemplating to cover. It applies to ventures such as IPAs. It would also apply to hospital-physician joint ventures (and to some hospital-hospital joint ventures) which are primarily investment vehicles for hospitals and professionals to better the health care system in their community and not devices to circumvent the intent of the pension law provisions protecting rank-and-file employees from unfair treatment. The Service's proposed regulations have been pending for 4 years, and the Service has been unwilling to declare that 414(m) does not apply to the ventures described above. The uncertainty of the application of 414(m) may chill the development of innovative and needed ventures providing essential health care delivery systems. (See Exhibit 8.)

## Proposals

There are various ways to amend 414(m) without undercutting the reasons for which it was enacted. The first, and preferred proposal, would be to amend the definition of any service organization contained in section 414(m)(2)(A) by adding the following language to the end of the section:

> (iii) At least 25 percent of the gross receipts of the business of such organization is derived from the performance of services for, or in regular association with, the first organization."

The percentage test would be the best approach since it clearly defines the scope of the provision without subverting the original intent to prevent physicians from incorporating their partnerships from which they derived all or substantially all of their income. With the percentage test being low, there is a safeguard in the statute from manipulation by incorporated partnerships of professionals.

Alternatively, if a percentage of the gross receipts test is not feasible, language such as the following might be added to section 414(m)(2)(A):

> (iii) The principal portion of the business of such organization is derived from the performance of services for, or in regular association with, the first organization.

The term "principal" is used elsewhere in the Code and has a defined, but not well defined meaning.

Each of the foregoing would permit the physicians and hospitals to participate in joint ventures without fear of compromising the validity of their pension plans.

Section 1115

**HOPKINS & SUTTER**
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COMMENTS ON THE TECHNICAL CORRECTIONS ACT OF 1987

H.R. 2636

JULY 17, 1987

## Proposal

The Technical Corrections Bill of 1987 should amend section 414(r)(8) of the Internal Revenue Code of 1986 (the "Code") as follows:

> (8) Affiliated service group. -- This subsection shall not apply in the case of any affiliated service group described in section 414(m)(2).

Section 414(r)(8), added to the Code by the Tax Reform Act of 1986, currently provides as follows:

> (8) Affiliated service group. -- This subsection shall not apply in the case of an affiliated service group (within the meaning of section 414(m)).

## Background

Section 414(r) sets forth the definition of "separate lines of business." This definition becomes relevant for purposes of the participation requirements applicable to qualified retirement plans in section 410(b) of the Code, generally for plan years beginning in 1989, and for purposes of the nondiscrimination requirements applicable to statutory employee benefit plans in section 89 of the Code, generally for plan years beginning in 1988. Sections 410(b) and 89 provide that their participation and nondiscrimination requirements, respectively, may be applied separately with respect to employees in each separate line of business maintained by an employer. I.R.C. §§ 410(b)(5) & 89(g)(5).

Sections 414(m)(1) and 414(t) of the Code provide that all employees of the members of an affiliated service group are treated as employed by a single employer for purposes of many employee benefit provisions, including sections 410(b) and 89.

Section 414(m)(2) defines an affiliated service group as (a) any service organization (called the "first service organization"), (b) any service organization which is an owner of the first service organization and regularly performs services for, or is regularly associated with the first service organization in performing services for third persons, and (c) any other organization which performs significant services for the first service organization of a type historically performed by employees and is in part owned by highly compensated employees of the first service organization.

Section 414(m)(5) of the Code provides that an affiliated service group also includes a group consisting of (a) an organization, the principal business of which is performing management functions for one organization (or such organization and related organizations), and (b) the organization (and related organizations) for which such management functions are performed.

Analysis

Section 414(r)(8) provides that the lines of business exception does not apply to affiliated service groups within the meaning of section 414(m). While this exclusion may be appropriate in the case of affiliated service groups defined in section 414(m)(2), it is entirely inappropriate and unjustifiable to the extent it applies to affiliated service groups under the management functions test in section 414(m)(5).[*] The abuse addressed in section 414(m)(5) is one in which management employees are employed by a separate corporation from rank-and-file employees in an attempt to avoid the nondiscrimination requirements applicable to employee benefit plans. This abuse is adequately addressed by section 414(r)(6) of the Code, which provides that the Secretary of the Treasury shall prescribe rules for the allocation of headquarters personnel among the lines of businesses of the employer and for the treatment of other employees providing services for more than one line of business of the employer.

Prohibiting any management function affiliated service group from using the lines of business exception under section 414(r)(8) creates the unintended and absurd result of prohibiting many large controlled groups of corporations from using the lines of business exception if the group has a holding company parent (or other affiliated management company) which provides management services to the operating companies in the group. This is precisely the type of group of corporations which the lines of business exception was designed to protect. For example, assume that a group of corporations includes a passenger airline, a hotel chain and a rental car company, each wholly-owned by a single, holding company parent corporation. Because each of the operating companies is wholly-owned by the parent company, these companies are part of a controlled group of corporations as defined in section 414(b) of the Code. If the other requirements of section 414(r) of the Code are met, the employees of each operating company may be treated separately for many employee benefit purposes under the lines of business exception. However, if the parent company or an affiliated management company provides management functions for the operating companies, then the group of corporations would be a management function affiliated service group under section 414(m)(5) of the Code and cannot take advantage of the lines of business exception which would otherwise apply to the group.

By prohibiting management function affiliated service groups from using the lines of business exception, section 414(r)(8) will cause many plans maintained by operating corporations which are part of conglomerates to fail to meet the participation requirements of section 410 of the Code. This result was obviously unintended. Section 414(r)(8) will also discourage groups of corporations from economizing by centralizing their management functions in a single entity. This result violates sound business policy and is arbitrary. We therefore request that the technical corrections suggested above be included in the Technical Corrections Bill of 1987.

---

[*] This comment is not intended to address affiliated service groups described in section 414(m)(2).

Stewart R. Shepherd
Fredric S. Singerman

HOPKINS & SUTTER

Section 1117

GINSBERG & FORMAN
ATTORNEYS AT LAW
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DALLAS, TEXAS 75201

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DONALD J. FORMAN
HOWARD A. WEINBERGER
DAVID G. ADLER
STANLEY C. SIMON

AREA CODE 214
744-0044

June 19, 1987

Mary M. Levontin, Esq.
Robert J. Leonard, Esq.
James C. Gould, Esq.
Harry J. Conaway, Esq.

Re: Technical Corrections Act of 1987 (H.R. 2636 and S. 1350)

Dear Mary, Rob, Jim, and Harry:

Sec. 111(m)(11) of the bill would amend section 4979(f)(2) of the 1986 Code to provide two rules on the taxation of excess contributions and excess aggregate contributions distributed within 2½ months after the end of the plan year. If the amount distributed were less than $100, it would be taxed when distributed; if $100 or more, it would be taxed in the prior year. The de minimus rule is intended to simplify reporting for recipients of small amounts.

If the plan is required to file an information return with the Internal Revenue Service which merely shows the amounts paid and the dates of payment, this provision would not create too many problems for the plan. A calendar year plan, for example, could include with each 1988 check a printed statement explaining that, if the amount was less than $100, it was taxable in 1988; if $100 or more, in 1987. On the other hand, if the plan is required to file information returns which show the year of taxability, there will be major problems for large plans.

The Southland Corporation Employees' Savings and Profit Sharing Plan is working as fast as it can to program the computer to make the required distributions before March 15, 1988. If it has to put additional steps into the program to show different dates of taxability in information returns, it may not be able to get the programming done in time.

I suggest that either the statute of the committee reports make it clear that the paying plan does not have to inform the payee or the IRS specifically in which year the payment is taxable. I also have alternative suggestion, which would greatly simplify plan administration and still achieve rough justice.

Instead of requiring payment within 2½ months after the end of the plan year and taxing amounts of $100 or more in the prior year, permit distribution not later than the end of the following plan year and require the distributee to include 110% of the amount distributed in income. If you think 10% is too rough, you could use the average underpayment rate for the calendar year as determined under section 6621(a)(2) of the 1986 Code. Both the payee and the Treasury would be in about the same place as they would have been under present law; and life would be easier for plan administrators, who would not have to rush, for payees, who would not have to file amended returns if they had filed before March 15, and for the IRS, which would not have to process amended returns.

Sec. 111A(g)(5) would add a new paragraph (5) to Sec. 4980A(d) of the 1986 Code. This new paragraph would permit a spouse, if the beneficiary of all of the interests in the deceased spouse's retirement plans, to elect (1) not to have the special estate-level tax apply and (2) to have any distributions received aggregated with the spouse's own distributions and taxed under the general rule. This is a good rule, but it needs one small modification to simplify estate planning.

Many individuals, fearing their spouses' improvidence, make their retirement benefits payable to trusts for the benefit of the spouses. This was recognized and accommodated in Sec. 401(a)(9)(B)(iii)(I).

The rule in Sec. 4980A(d)(5) should be extended so that the election could be made if the spouse and/or trusts for the benefit of the spouse are beneficiaries of all interests in the retirement plans. If you wanted, the trusts could be limited to those in which a spouse was entitled to all the income. See paragraphs (5) and (7) of Sec. 2056(b).

Sincerely yours,

Stanley

Stanley C. Simon

## Section 1121

BOARD OF TRUSTEES
GARY R. RODGERS, CHAIRMAN
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MARCUS L. YANCEY, JR.

CLAYTON T. GARRISON
EXECUTIVE DIRECTOR

EMPLOYEES RETIREMENT SYSTEM OF TEXAS
18TH & BRAZOS STREETS
P.O. BOX 13207
AUSTIN, TEXAS 78711-3207
512 476-6431

July 6, 1987

Mr. Robert J. Leonard
Chief Counsel
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D. C. 20515

Re: H.R. 2636, The Technical Corrections Act of 1987

Dear Mr. Leonard:

Thank you for the opportunity to comment on H.R. 2636, The Technical Corrections Act of 1987. The Trustees of the Employees Retirement System of Texas (ERS) believe that an additional item of correction should be in the bill which would exempt state and local government plans and their participants from the Tax Reform Act's mandatory distribution rules and excise tax provisions for participants who attain age 70 1/2.

The interplay between the Tax Reform Act of 1986 and the Age Discrimination in Employment Act (ADEA) amendments creates a situation in which a plan participant must take distributions from the plan at age 70 1/2 yet still accrue additional pension benefits by continuing to work. That appears to be a conflicting and, for the ERS, a costly policy.

Enclosed please find a copy of an actuarial analysis prepared by the ERS's consulting actuaries. The actuaries have concluded that the combined effect of the Tax Reform Act of 1986 provision and the ADEA amendments is to increase the unfunded actuarial accrued liability by $87.4 million and to increase the period required to amortize the unfunded actuarial accrued liability from 18.1 years to 22.2 years, an increase of 4.1 years.

The provisions of the federal tax law that would be affected are:

1. Section 401(a)(9)(C), Internal Revenue Code [26 U.S.C. §401(a)(9)(C)], as amended by the Tax Reform Act of 1986, Pub. L. 99-514, Title XI, §1121(b) and (d); and
2. Section 4974, Internal Revenue Code (26 U.S.C. §4974), as amended by the Tax Reform Act of 1986, Pub. L. 99-514, Title XI, §1121(a)(1) and (d).

Our interest is simply to have state and local governmental plans and their participants excluded from the mandatory distribution and excise tax rules contained in the above-cited statutory provisions. We are not asking for any changes with respect to federal governmental plans or private plans. As we understand these matters, the evil that these provisions were designed to remedy is abuses in private plans covering wealthy individuals that led to the accumulation of assets for non-retirement purposes. We do not believe that evil exists with respect to state and local governmental plans. Therefore, it seems inappropriate to apply the remedy to situations in which the evil does not exist. The only justification for including state and local governmental plans is the adoption of a "purist" approach to retirement policy. We believe such a "shot gun" approach creates unnecessary burdens for state and local governmental plans and their participants. It is also our understanding that by exempting state and local plans that the revenue impact would be insignificant.

For more detailed information concerning the proposed amendments, please refer to the enclosed April 28, 1987 memorandum from Anthony Wilson, our law clerk.

We thank you once more for the opportunity to present our comments and recommendations and we hope you will consider them favorably.

If you have questions or need additional information, please let me know.

Sincerely,

Clayton T. Garrison
Executive Director

CTG:GDH:cm

Enclosures

(Attachment retained in Committee files.)

# POSITION OF NATIONAL COUNCIL ON TEACHER RETIREMENT ON MANDATORY DISTRIBUTION OF PENSION BENEFITS AT 70 1/2

The National Council on Teacher Retirement (NCTR) seeks an exemption for state and local employees from the mandatory pension distribution provision contained in the Tax Reform Act of 1986 (TRA Sec. 1121).*

TRA §1121 requires the commencement of pension payouts for all workers upon attainment of age 70 and one-half. This means that full-time public employees will be entitled to full salary, plus full pension benefits upon reaching 70 1/2. In some states, the total payment could be as high as 175% of salary. This is a strong incentive for continued employment, which, particularly in regard to teachers, goes against well developed public policy.

TRA §1121, according to legislative history, was designed to correct an abuse in the private sector, whereby well-to-do individuals were taking advantage of the tax benefits that accompany pension savings by creating pension plans that they used for estate purposes rather than as retirement income. Enforcement was difficult because it could not be determined whether these individuals were or were not still in the work force.

Neither problem exists in the public sector. The laws governing public sector retirement do not offer an opportunity for using the pension as an estate planning device. Many states, such as Ohio and Idaho, provide that upon the death of the member, the employer contribution can be passed on only to a surviving spouse or dependents (children or parents, in most cases). If neither spouse nor dependents survive the member, only his contributions (after tax in most cases) can be left to his estate. The longer the member works, the less likely he is to have dependents. Further, the total value of any individual member's pension is reduced the longer he postpones retirement.

Virtually all 50 states have laws requiring a public employee to first terminate service before applying for his pension benefits; these laws directly proscribe the receipt of a pension while the participant is still working. They reflect a strong public policy against "double dipping." Where a retiree subsequently resumes service (except on a part-time or emergency basis), most states require that pension payments be interrupted; some states provide for the creation of a new pension account, from which additional benefits will be paid when the individual affected "retires" again.

The opportunity for the kind of abuse in the private sector that gave rise to §1121 simply doesn't exist in the public sector. In addition, the revenue consequences of exempting the public sector from the provisions of §1121 are negligible. Balanced against the argument for uniformity that resulted in §1121's being applied to the public sector are detailed and well justified policies affecting the terms of public employment that have been enacted by the state legislatures and that will have to be totally revised if §1121 is applied to the public sector. These policies include decisions not to offer special financial inducements to teachers and other public employees to continue working beyond age 70; they also reflect judgments that public revenues raised from the general taxpayers should not be applied to encourage "double dipping" and to overcompensate older workers. The Congress, in seeking to prevent tax abuses in the private sector, is forcing a different kind of tax abuse in the public sector.

---

*NCTR is a membership organization of 45 state, 13 local and two territorial retirement systems, some of which serve teachers exclusively, others of which include other state and local employee groups. NCTR member plans include over five million active participants.

In addition to the fact that §1121 is not sound policy for the public sector, it is also a nightmare to administer. Many states calculate retirement benefits as a percentage of the average of the three highest final years of salary. This means that where a retiree continues to work, with attendant salary increases, his pension payment will have to be recalculated on a monthly basis. For most states, this will require manual calculations, adding greatly to the administrative burden of the retirement systems.

Finally, administration of the amendment will impose a heavy and unnecessary financial burden on state retirement systems. For example, actuaries for the New York State Teachers Retirement System estimate that §1121 will cost the system an additional $10 million per year. The South Carolina Retirement System reports an estimated first year cost of $2.5 million, with the cost increasing each year thereafter. The Employees Retirement System of Texas states that its actuaries estimate the combined effect of the TRA and the ADEA amendments* as increasing the system's unfunded actuarial accrued liability of $87.4 million (see attached documentation), and the Florida Retirement System states that the cost of implementing the mandatory payout provisions alone will be $7 million for just the first year.

For the above reasons, because requiring a public employee who reaches 70 and one-half to begin receiving his pension is unnecessary and bad public policy and because it will cost state retirement systems millions of dollars, NCTR respectfully urges the Congress to exempt public retirement systems from TRA §1121 as part of the Technical Corrections Act. In this position, it is joined by the National Conference of State Legislatures, the National Council of Public Employee Retirement Systems, the Government Finance Officers Association, and the National League of Cities.

---

*Virtually all of the state retirement systems express concern that the combination of §1121 and the recent amendments to the ADEA, removing the cap of age 70, will put them in an untenable position: if they require employees to retire as a precondition to receiving retirement benefits (in conformance with state law requirements), they will be vulnerable to challenges of age discrimination under ADEA.

EXHIBIT

BOARD OF TRUSTEES
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MAURICE BECKHAM, VICE CHAIRMAN
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EMPLOYEES RETIREMENT SYSTEM OF TEXAS
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February 2, 1987

Mr. Randy Hardock
Senate Finance Committee
Room 205
Dirkson Senate Office Building
Washington, D.C. 20510

RE: Mandatory Distribution at Age 70 1/2; ADEA Amendments

Dear Mr. Hardock:

Thank you for taking the time on January 29, 1987 to discuss the concerns of the Employees Retirement System of Texas (ERS) with respect to the Tax Reform Act of 1986 provision requiring mandatory distributions from qualified plans at age 70 1/2 and the amendments to the Age Discrimination in Employment Act (ADEA) which became effective on January 1, 1987.

The interplay between the Tax Reform Act of 1986 and the ADEA amendments creates a situation in which a plan participant must take distributions from the plan at age 70 1/2 yet still accrue additional pension benefits by continuing to work. That appears to be a conflicting and, for the ERS, a costly policy.

Enclosed please find a copy of an actuarial analysis prepared by the ERS's consulting actuaries. The actuaries have concluded that the combined effect of the Tax Reform Act of 1986 provision and the ADEA amendments is to increase the unfunded actuarial accrued liability by $87.4 million and to increase the period required to amortize the unfunded actuarial accrued liability from 18.1 years to 22.2 years, an increase of 4.1 years.

We have not yet analyzed the effect of the federal law changes on the judicial retirement systems which are administered by the ERS. Also, the federal law changes would probably have a significant impact on the Teacher Retirement System of Texas (TRS). The TRS is approximately four times larger than the ERS in terms of assets, members, and retirees.

Thank you again for your interest with respect to this matter. We would certainly appreciate any help you could give us concerning the exemption of governmental retirement plans from the application of the federal law provisions discussed in this letter.

Sincerely,

James T. Herod

JAMES T. HEROD
General Counsel

EXHIBIT

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CONSULTING ACTUARIES

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DAVID HUFF, F.S.A.
ROBERT M. MAY, F.S.A.
J. CHRISTOPHER McCAUL, A.S
CLIFTON M. MITCHELL, F.S.A
MICHAEL J. MUTH, A.S.A.
RONALD W. TOBLEMAN, F.S.A
EUGENE WISDOM, F.S.A.

December 30, 1986

Mr. Clayton T. Garrison
Executive Director
Employees Retirement System of
Texas
Post Office Box 13207
Austin, Texas 78711-3207

Re: Actuarial Analysis of ERS
Amendments Due to Certain
Changes in Federal Law

Dear Mr. Garrison:

At your request, we have made an actuarial analysis of the combined effect of certain changes in federal law made in 1986 by Congress. Among many changes made in the Tax Reform Act of 1986 was one that requires that distributions under all qualified plans must commence no later than April 1 of the calendar year following the calendar year in which the participant attained age 70 1/2, without regard to the actual date of retirement, beginning January 1, 1989, in order to avoid a significant tax penalty. This penalty would be in the form of a 50% excise tax to the employee. In addition, the Age Discrimination in Employment Act was amended allowing people to work beyond age 70 and to continue to accrue benefits. In order to comply with these two changes the Employees Retirement System of Texas (ERS) will have to have its law amended to allow certain members of ERS to begin receiving a benefit while still employed by the state and to continue accruing benefits.

It is estimated that this amendment would increase the unfunded actuarial accrued liability by $87.4 million as of August 31, 1986, and would increase the period required to amortize the unfunded actuarial accrued liability from 18.1 years to 22.2 years, an increase of 4.1 years. The attached appendix shows the actuarial assumptions and the methodology used in the analysis. The economic effect of this amendment on ERS would be to weaken its actuarial and financial condition because it would increase benefits for certain members working beyond age 70 without providing additional financing.

We certify that the contents of this letter fulfill the requirements for an actuarial analysis in both the House rules and the Senate rules in effect for the regular session of the 69th Legislature.

Sincerely,

Robert M May
Robert M. May, F.S.A.

Mark R. Fenlaw
Mark R. Fenlaw, F.S.A.

## Appendix

1. This actuarial analysis was made using the actuarial assumptions which were used for the August 31, 1986 actuarial valuation and which were adopted by the Board of Trustees at their regular meeting of December 19, 1986. Included in these assumptions are an assumed rate of investment return of 8.5% per year and assumed rates of salary increase which average 9.15% per year over a member's career. The salary increase assumption is for individual members and includes across-the-board increases of 6.25% per year plus merit, promotion, and longevity increases which average 2.90% per year over a member's career. This assumption differs from the payroll increase assumption of 8.25% per year, which is for the aggregate payroll of all contributing members and which consists of 6.25% for across-the-board increases plus 0.5% for growth in number of members plus 1.5% for the aggregate effect of changes in salary distribution and of merit, promotion, and longevity increases. The complete set of actuarial assumptions used in making this analysis is shown in "Report of the Actuarial Investigation for Fiscal Years 1982-1985 and Recommendation of Actuarial Assumptions".

2. This analysis has been based on the system's actuarial valuation as of August 31, 1986, which is the most recent valuation of the system. The actuarial cost method used was the Entry Age Actuarial Cost Method. The unfunded actuarial accrued liability is to be amortized with a level percent of payroll which is the total contribution rate minus the normal cost contribution rate.

3. The methodology used was to estimate the additional amounts in retirement benefits that would be paid each year beginning in 1989 as the result of the amendment to ERS to allow certain members of ERS to begin receiving a benefit while still employed by the state in order to comply with federal law. The amounts for all future years were discounted at 8.5% interest to the August 31, 1986 valuation date.

4. Specific assumptions

   a. ERS would amend its law to allow payment of retirement benefits to members still employed by the state at ages above 70. The payments would have an effective starting date of March 31 of the calendar year following the calendar year of the attainment of age 70 1/2, beginning March 31, 1989.

   b. The average age at the effective starting date would be 71 and 3 months.

   c. The average period between the effective starting date and the termination of employment (the true retirement date) would be 3 years and 3 months. (This assumption is based on the average age at retirement of 74 1/2 of 66 males and 57 females who retired at ages 71 and above during the four-year period ending August 31, 1985.)

d. There would be 30 new members per year who attain age 70 1/2 in the previous calendar year but who continue their employment with the state at least beyond March 31. (This assumption is based on the study of the 123 members who retired at ages 71 and above during the four-year period ending August 31, 1985 and of the 74 contributing members at ages 71 and above who were employed by the state as of August 31, 1985.)

e. The total benefit would be recomputed as of each March 31 to reflect the additional service and the higher final average compensation.

f. The average service would be 18 years when the benefit first begins.

g. The average final average compensation would be $2,000 for 1989 and would increase 7.75% per year, the ultimate annual rate of increase in the salary increase assumption.

EXHIBIT

By: Farabee S.C.R. No. 32

## SENATE CONCURRENT RESOLUTION

WHEREAS, The Tax Reform Act of 1986 enacted by the 99th Congress of the United States will require governmental retirement plans to begin payments to public officers and employees who attain age 70-1/2 years even while such persons continue their employment and earn full compensation for that employment; and

WHEREAS, Amendments to the Age Discrimination in Employment Act enacted by the 99th Congress of the United States prohibit mandatory retirement solely on the basis of age and generally require governmental retirement plans to grant additional retirement credit to an employee even after the employee begins receiving payments from the plan because of the attainment of age 70-1/2 years; and

WHEREAS, A combined effect of these laws will be to require states to allow public officers and employees who are 70-1/2 years old and older to earn their full state salaries while receiving full state retirement benefits, and even earn additional retirement benefits for such continued employment; and

WHEREAS, These laws require the state to discriminate against public officers and employees who are less than 70-1/2 years of age in the compensation the state pays for services, impose on the state additional costs of governmental retirement plans, and impair the effective use of governmental retirement plans to induce retirement of public officers and employees and thereby reduce salary costs; and

WHEREAS, The actuarial effect of these laws upon the Employees Retirement System of Texas alone, one of six statewide retirement systems, is to increase the unfunded actuarial accrued liability of the system by $87.4 million as of August 31, 1986, and to increase by 4.1 years the period required to amortize the unfunded actuarial accrued liability of the system; now, therefore, be it

S.C.R. No. 32

RESOLVED, That the 70th Legislature of the State of Texas do hereby request and urge the 100th Congress of the United States to amend the tax laws of the United States to exempt governmental retirement plans and their participants from the provisions of the Tax Reform Act of 1986 which mandate distribution to a pension plan participant when that participant attains age 70-1/2 years and impose an excise tax on the participant for failure to take a required distribution; and, be it further

RESOLVED, That the Texas Secretary of State forward official copies of this resolution to the President of the United States, the Speaker of the United States House of Representatives, the President of the United States Senate, and to each member of the Texas delegation to the 100th Congress of the United States, with the request that this resolution be officially entered in the Congressional Record as a memorial to the Congress of the United States of America.

W.P. Clements Jr.
Governor of Texas

WP Hobby
President of the Senate

Gib Lewis
Speaker of the House

I hereby certify that S.C.R. No. 32 was adopted by the Senate on February 16, 1987.

Betty King
Secretary of the Senate

I hereby certify that S.C.R. No. 32 was adopted by the House on February 18, 1987.

Betty Murray
Chief Clerk of the House

BRUCE F. VENTO
4TH DISTRICT, MINNESOTA

2304 RAYBURN HOUSE OFFICE BUILDING
WASHINGTON, DC 20515
(202) 225-6631

DISTRICT OFFICE

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Congress of the United States
House of Representatives
Washington, DC 20515

HOUSE COMMITTEE ON
INTERIOR AND INSULAR AFFAIRS

CHAIRMAN
SUBCOMMITTEE ON NATIONAL PARKS
AND PUBLIC LANDS

HOUSE COMMITTEE ON
BANKING, FINANCE AND
URBAN AFFAIRS

HOUSE SELECT COMMITTEE
ON AGING

July 14, 1987

Honorable Dan Rostenkowski
Chairman
Ways & Means Committee
1102 Longworth HOB
Washington, D.C. 20515

Dear Mr. Chairman:

I am writing on behalf of a group of constituents regarding a technical correction to the Tax Reform Act with respect to the mandatory distribution of pension funds.

The issue of concern is the mandatory distribution of pension benefits beginning at age 70 1/2. The distribution requirement causes both policy and administrative burdens for state and local public pension systems. The Public Employees Retirement Association of Minnesota is seeking an exemption for state and local public pension systems. Please find enclosed further information regarding this issue.

I greatly appreciate your attention to this matter.

Warm regards.

Sincerely,

Bruce F. Vento

Bruce F. Vento
Member of Congress

BFV:cjh

THIS STATIONERY PRINTED ON PAPER MADE WITH RECYCLED FIBERS

Public Employees Retirement Association of Minnesota
Suite 200 — Skyway Level
514 St. Peter Street
St. Paul, Minnesota 55102
612-296-7460

PERA

June 29, 1987

Honorable Bruce Vento
United States House of Representatives
2433 Rayburn House Office Building
Washington, D.C. 20515

Dear Representative Vento:

On behalf of the 93,000 active members and the 23,000 benefit recipients of the Public Employees Retirement Association (PERA) of Minnesota, I am writing to urge your support to exempt county, city, municipal and school district employees from the new federal law that requires mandatory distribution of pension benefits beginning at age 70½ for all state and local government employees. The new distribution requirement creates both policy and administrative burdens for state and local public pension systems such as PERA, and we request your assistance in having this exemption made part of the technical corrections bill to Section 1121 of the Tax Reform Act (TRA) of 1986.

Under prior federal law, the distribution of pension benefits was required to begin no later than April 1 of the calendar year following the year in which the employee attained age 70½ or the employee retired, whichever is later. Section 1121 of the TRA, however, eliminated the second element for determining when benefit payments must begin. The effect of this change is that an individual who works beyond age 71 must collect both a salary and a pension benefit at the same time from the same employer, as well as continue to accrue additional future retirement benefits. Failure to distribute pension benefits results in a 50% non-deductible excise tax imposed on the employee on the amount that should have been distributed.

This provision was intended to preclude highly paid private sector employees from using a pension plan as an estate planning device rather than for retirement purposes. This practice resulted in the avoidance of, or reduction in, taxes. However, state and local government pension systems operate under laws which prevent retirement benefits from being used in this way. In addition, projected actuarial valuations of this provision show that state and local government costs will be substantial because of increased benefit liability costs to public pension funds due to the longer payment period and additional amount of retirement benefits which would have to be funded to comply with federal law.

The new distribution requirement is also in conflict with the Age Discrimination in Employment Act (ADEA) that prohibits an employer from establishing a mandatory retirement age and from using age as a criterion for stopping retirement plan benefit accruals.

The additional tax revenue that the federal government hopes to produce under the new distribution provision will be minimal from public employees because of the small number of workers affected and their relatively low salaries. In PERA, out of the 116,000 active and retired members, only 167 members over age 70 having an average monthly salary of $573.42 would be affected by the new distribution requirement.

The PERA Board of Trustees requests your support in exempting state and local public employees from the mandatory distribution rule in the technical corrections bill to the Tax Reform Act of 1986 that is currently being drafted by the Senate Finance Committee and the House Ways and Means Committee.

Sincerely,

James M Hacking

James M. Hacking
Executive Director

Section 1122

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July 1, 1987

Robert Leonard, Esq.
Chief Counsel
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

RE: Technical Corrections Bill of 1987
(H.R. 2636)
Tax Reform Act Section 1122
Internal Revenue Code Section 402(e)

Dear Mr. Leonard:

The purpose of this letter is to point out desirable technical corrections to the Tax Reform Act of 1986. The issue relates to the taxation of lump sum distributions under Section 402 of the Internal Revenue Code.

Under prior law, a taxpayer could apply long term capital gain treatment to part of a lump sum distribution and 10-year averaging to the balance (the "ordinary income portion"). If part of a distribution was treated as a long term capital gain, then the ordinary income portion was less than the total taxable amount, and the separate 10-year averaging tax was only a fraction of the initial separate tax (which was computed on the basis of the total taxable amount).

Section 1122 of the Act repealed much of this but provided for limited grandfathering of long term capital gain treatment.

The Act deleted the definition of "ordinary income portion" (but left a reference thereto in Code §402(e)(1)(A)), eliminated the initial separate tax, and provided for imposing the separate tax on the entire total taxable amount.

The effect of this could be double taxation of the capital gain portion in the case of a grandfathered taxpayer. This was clearly not intended. The Blue Book, presumably referring to Code §402(e)(4)(L), states at page 723, that "[a]s under prior law, [the 10-year averaging] election may be made with respect to the entire lump sum distribution or with respect solely to that portion that is not eligible for capital gains treatment".

This situation could be corrected by adding to Section 1122(h) of the Act a paragraph to the following effect (based on old Code Sections 402(e)(1)(B) and (E)):

> If an election is made under paragraph (3) or (4), then any tax imposed under Section 402(e)(1) of the Internal Revenue Code of 1986 shall be limited to the amount computed thereunder multiplied by a fraction, the numerator of which is the ordinary income portion of the lump sum distribution for the taxable year and the denominator of which is the total taxable amount of such distribution for such year. For purposes of this paragraph, the term "ordinary income portion" means, with respect to a lump sum distribution, the total taxable amount thereof reduced by the portion thereof treated as a long term capital gain.

In addition, Code §402(e)(1)(A) might be amended to delete the reference to "ordinary income portion," and Code §402(e)(4)(L) might be deleted as deadwood. Pre-1974 and post-1973 participation, while still relevant under the grandfather provisions in the Act, are no longer relevant under the Code.

Thank you for your consideration of this issue.

Very truly yours,

Thomas P. Atkins

321 S. Findlay St.
York, PA 17402
July 1, 1987

Mr. Robert Leonard
Chief Council Ways and Means Committee
1102 Longsworth
House Office Building
Washington, D.C. 20515

Dear Mr. Leonard:

I have been informed by Congressman Goodling's Office that I should write you concerning the Technical Correction's Bill (HR2636) to the Tax Reform Act of 1986 now under consideration.

I am especially concerned, as are all members of the Pennsylvania Public School Employees' Retirement System (PSERS), about the effect the tax laws have on option 4 of our retirement system. In a nut shell from September 1950 until January 1, 1983 I paid federal income tax on all of my contributions to the PSERS. Option 4 allows me to take this amount in a lump sum and not pay federal income tax because the federal income tax has been paid. This amount of my tax paid contribution has been documented by PSERS. Under the Tax Reform Act of 1986 if I choose option 4 I must pay federal income tax on the same money that I have already paid federal income tax on. I have been told by Congressman Goodling's Office that this is not considered DOUBLE TAXATION. How can you call it anything but DOUBLE TAXATION?

My wife and I officially retired from the teaching profession June 11, 1987. We have 90 calendar days from that date to select a retirement option. Once the option has been selected it may not be changed. Time is running out. For several years we have been planning to select option 4 and invest the money to supplement our income. With the added tax burden this may not be to our advantage.

It is our hope that the Technical Corrections Bill will eliminate this injustice in the present tax law.

I would appreciate a reply--if only a confirmation that you received this letter.

Sincerely yours,

Richard E. Bowen

Richard E. Bowen

**Chevron Corporation**
225 Bush Street, San Francisco, CA 94104-4289

Louis Fernandez, Jr.
Vice President

July 15, 1987

Tax Reform Act of 1986
Technical Corrections Act
(H.R. 2636 and S. 1350)

Code § 72 Basis Recovery

Congressman Dan Rostenkowski, Chairman
Committee on Ways and Means
1102 Longworth House Office Building
Washington, D.C. 20515

Dear Chairman Rostenkowski:

On behalf of thousands of Chevron Corporation and former Gulf Oil Corporation employees, we offer the following comments on H.R. 2636 and S. 1350, the proposed Technical Corrections Act of 1987. Our comments relate to troublesome technical problems concerning the taxation of pension plan distributions. In addition, we offer what we hope is a reasonable suggestion for resolving the issue.

As you may recall, Chevron acquired Gulf Oil Corporation in 1984. Effective July 1, 1986 the defined benefit plans of both corporations were merged into what is now the Chevron Retirement Plan. Thousands of active employees made contributions many years ago to the qualified retirement plans of both corporations, but the merged Plan is no longer contributory.

The Plan provides a form of distribution consisting of a lump-sum refund of employee contributions (and interest) plus a reduced annuity. Under prior law, employee contributions could be recovered first if the refund plus annuity option was selected. The new law preserves this treatment, but only if the refund is received before separation from service. Our refund is paid after separation from service but before the reduced annuity payments commence. Therefore, our refund is not eligible for the new law basis-recovery-first rule.

Under the new law, many retiring employees are now subject to complex "exclusion ratio" rules under which they are deemed to recover their own after-tax contributions gradually over the many years of retirement. The new rules cause great consternation among retirees and are difficult and expensive to administer.

We firmly believe that these problems are not justified by the small amounts involved and could be handled more simply by a "transition rule" or "de minimis" exception that would permit tax-free recovery as under prior law. Using active Chevron employees as an example, we estimate that under the new rules their average contributions of about $1,600 would result in an annual tax-free recovery of less than one percent of their annuity payments. It would be simpler for all, including the IRS, if these amounts could be recovered when the annuity first commences. Obviously, any revenue effect would be minuscule.

Section 111A(b) (11) of H.R. 2636 and S. 1350 extends the new law basis-recovery-first rule to refunds just like ours, but the section is limited to state plans. We ask for a narrow transition rule making section 111A(b) (11) treatment available to participants in other plans, at least where (1) the employee contributions were made before ERISA, and (2) the amount of employee contributions being recovered is relatively small ($7,500 or less).

Enclosed is a memorandum which describes this issue in detail and includes possible statutory language that might be used to accomplish the suggested changes.

We thank you for your consideration of this suggestion. If you or your staff desire further information or wish to discuss this issue, please do not hesitate to contact me or our Washington representative, Mr. Kevin Riordan at 457-5800.

Sincerely,

## Memorandum

San Francisco, California
July 16, 1987

**TAX REFORM ACT OF 1986**
**TECHNICAL CORRECTIONS BILL**
**(H.R. 2636 AND S. 1350)**
**CODE SECTION 72 BASIS RECOVERY**

### FACTS

Chevron Corporation acquired Gulf Oil Corporation in 1984. Chevron maintained the Chevron Annuity Plan and the Gulf Pension Plan (both defined benefit pension Plans), which were merged on July 1, 1986 to form the Chevron Retirement plan. Until 1971, the Gulf Plan had an employee contribution feature and, until mid-1971, the same was true of the Chevron Annuity Plan. Both Plans credited the employee contribution amounts with a stated amount of interest until distribution. No in-service withdrawals of employee contributions were ever permitted under either Plan.

As of 12/31/86, about 20% of the active employees participating in the merged plan had a balance of after-tax contributions made before mid-1971. The following table shows the distribution of the amount of contributions made by these 8,500 active employees.

| Amount of Contributions | | | | |
|---|---|---|---|---|
| $ 0 | to | 1,000 | = | 47.0% |
| 1,000 | to | 2,000 | = | 22.0 |
| 2,000 | to | 3,000 | = | 14.0 |
| 3,000 | to | 4,000 | = | 10.0 |
| 4,000 | to | 5,000 | = | 4.0 |
| 5,000 | to | 6,000 | = | 1.5 |
| 6,000 | to | 7,500 | = | 1.0 |
| Over | to | 7,500 | = | 0.5 |
| | | | | 100.0% |

Under the pre-merger Gulf Plan, the so-called "Option C" form of distribution allowed a participant who retired and was entitled to receive his benefits to elect to receive a lump-sum refund of his employee contributions plus interest, and an annuity actuarially reduced to reflect the refund of those employee contributions plus interest.

After the merger of the Gulf and Chevron Plans on July 1, 1986, Option C was retained for former Gulf employees and, if the problems under the 1986 Act can be satisfactorily resolved, it may be extended to all participants.

The Chevron Retirement Plan provides for individual life and for 50% and 100% joint and survivor forms of annuity distribution, either in combination with or without the Option C refund feature described above. The Plan also provides a lump sum form of distribution.

## THE LAW RELATING TO "OPTION C"

Under the Code prior to the Tax Reform Act of 1986 ("1986 Act"), if a qualified pension plan made a distribution before a participant's annuity starting date of an "amount not received as an annuity," the distribution was includible in the participant's gross income only to the extent it exceeded the participant's investment in the contract, or basis. Such an amount received on or after the annuity starting date was fully included in income. As amended by the 1986 Act, present law provides generally that a pre-annuity starting date distribution of an amount not received as an annuity is subject to the new pro-rata basis recovery rules. However, under new Code section 72(e)(8)(D) pre-1987 basis may be recovered first if the plan permitted in-service withdrawals of employee contributions on May 5, 1986. An amount not received as annuity that is made on or after the annuity starting date continues to be fully includible in gross income under both old law and present law.

## DISCUSSION OF OPTION C ISSUES

Under present law, retiring Chevron Retirement Plan paticipants electing Option C can only recover their old employee contributions first if the Plan could meet the requirements of new Code section 72(e)(8)(D). However, ensuring that the lump sum refund payment always actually precedes the annuity starting date is sometimes difficult because the annuity starting date can be as early as the first day of the month coinciding with or following retirement. In fact, the first annuity check is actually issued at the end of that month for that month. Moreover, even if Chevron could resolve the annuity timing problem, the Plan would be barred from Code section 72(e)(8)(D) treatment for the simple reason that on May 5, 1986, it did not permit withdrawals of employee contributions before separation from service, even though it did permit them (in the form of the Option C election to receive a lump sum refund) at separation from service.

If the basis-recovery-first rule under Code section 72(e)(8)(D) were made available to retiring Chevron Plan participants, the revenue loss would be insignificant, and the tax treatment not inconsistent with Congress' reasons for changing the law. In its General Explanation of the Tax Reform Act of 1986 (the "Bluebook"), the Joint Committee on Taxation states that Congress believed that the prior "basis recovery rules for distributions before retirement permitted the accelerated tax-free recovery of employee contributions and thus further encouraged the use of tax-favored retirement arrangements for nonretirement purposes." Since a basis-recovery-first rule under the Chevron Plan would only apply to participants terminating employment, and would only allow the accelerated tax-free recovery of a very small benefit (the employee contributions made more than 10 years earlier), it would not encourage the use of the Plan for nonretirement purposes.

## SUGGESTED TECHNICAL CORRECTION FOR OPTION C

Section 111A(b)(11) of the Technical Corrections Bill amends section 1123(h) of the 1986 Act in such a way that, if it were applicable to the refund of employee contributions and interest under the Chevorn Retirement Plan, the participant could recover his basis first from the "Option C" lump sum refund, so long as it was paid with or before the first annuity payment. However, the rule of this section is only applicable "(i)n the case of a plan maintained by a State which on May 5, 1986, permitted withdrawal by the employee of employee contributions (other than as an annuity)."

We anticipate that Congress would be unwilling to increase the availability of section 111A(b)(11) to any great extent. Therefore we suggest that it be limited to plans that do not currently allow employee contributions and further limited to those plan participants whose employee contributions were made more than 10 years ago. If it is felt necessary, this relief could be further limited to situations where there is only a small amount of employee contributions. The following revision to section 111A(b)(11) retains the current rule for State plans and extends it as we have suggested:

"(11) Section 1123(h) of the Reform Act is amended by adding at the end thereof the following new paragraph:

'(9) SPECIAL RULE FOR CERTAIN PLANS. - -

(a) IN GENERAL. - - In the case of any plan to which this paragraph applies, section 72(e) of hte Internal Revenue Code of 1986 shall be applied - -

(i) without regard to the phrase "before separation from service' in paragraph 8(D), and

(ii) by treating any amount received (other than as an annuity) before or with the first annuity payment as having been received before the annuity starting date.

(B) PLANS TO WHICH THIS PARAGRAPH APPLIES. - - This paragraph shall apply to any plan - -

(i) maintained by a State which on May 5, 1986, permitted withdrawal by the employee of employee contributions other than as an annuity), or

(ii) which on May 5, 1986, did not permit employee contributiosn to be made ot the plan.

This paragraph shall apply with respect to an employee participating in a plan described in clause (B) (ii) only to the extent that all of the employee contributions credited to the employee under the plan (or a predecessor plan) on May 5, 1986 had been made to the plan (or a predecessor plan) prior to 1976."

Clause B(ii) could be further limited to make absolutely certain that the basis-recovery-first rule is available only to participants with small amounts of employee contributions by the addition of the following at the end of this suggested section 1123(h)(9) of the 1986 Act:

"and do not exceed $7,500 on May 5, 1986."

CHEVRON BENEFITS STAFF

118 Sherrie Drive
Pittsburgh, Pa. 15239
July 19, 1987

The Honorable Dan Rostenkowski
Chairman, House Ways and Means Commitee
2111 Rayburn House Office Building
Washington, D.C. 20515

Sir:

Please add my name and that of my husband to the legislation proposals now in the U.S. House of Representatives concerning the unfairness of the new law dealing with the Pension and Annuity Income (IRS Publication #575).

My husband retired from the U. S. Postal Service on July 3, 1986. As you know, the lump sum we received was his own earned salary on which Federal, State and Local taxes were paid at the time it was received by him. No other funds from any other source was added to this. To tax this money again is beyond our comprehension, no matter how the government chooses to word it.

Other problems have arisen in view of the above. We have lightly discussed it with an IRS employee and have discovered even they are confused.

We were told we probably will have to include this as taxable income on our Income Tax return for 1987. Wonderful! This puts us in the 28% tax bracket, which will require not only more taxes being paid on the lump sum, but also 28% payable on my husband's reduced retirement check and his $8800 a year part-time job at a local hospital. A large chunk of the lump sum has just left us again.

In addition, our daughter is entering Saint Vincent College this fall. We have filled out all Pennsylvania Higher Education Assistance Agency (PHEAA) forms, including a Special Condition form since due to the retirement our 1987 income would be much reduced from the 1986 income. My daughter will receive some welcome aid from PHEAA (not the Pell Grant) and we are indeed thankful.

PHEAA states on all its forms that if you file a fradulant form you may have to pay back three times the amount of the Grant and you can be prosecuted. Now, if this lump sum must be claimed as income for 1987, have we unintentionally filled out a fradulant Special Condition form? If we would have to repay this, more of our lump sum has just left us.

If we must claim it as income, and my husband's entire earnings are taxed at 28%, and if this unfair regulation is found to be unlawful at a later date, will the taxes on all his income (the difference between the 15% we normally would pay and the 28% we would be forced to pay) be returned to us? Those are some of the questions we cannot get an answer to from the IRS as they seem to be as uninformed as we are.

We have never had much, raising four sons and one daughter living mainly from pay to pay. There was not much to put away for our "old age". We determined that this lump sum would be all we would have, so we put it in a CD and the interest accrued would bring the reduced retirement check up close to the original before the annuity was received. Seems to us, almost all of it is going back to the government in one way or another. Then we will be left with a reduced monthly check and nothing in the bank. The wording in IRS Publication #575 may find this just but it is not fair - there is a difference.

We both urge you to correct this unfair regulation.

Sincerely,

Barbara Cutone

(Mrs. Michael Cutone, Jr.)

Rep. Dan Rostenkowski, Chairman
House Ways and Means Committee
Room 1102 LHOB
Washington, D.C. 20515

Dear Rep. Rostenkowski:

It is very important to thousands of teaching professionals for this bill to be reported out of committee as quickly as possible.

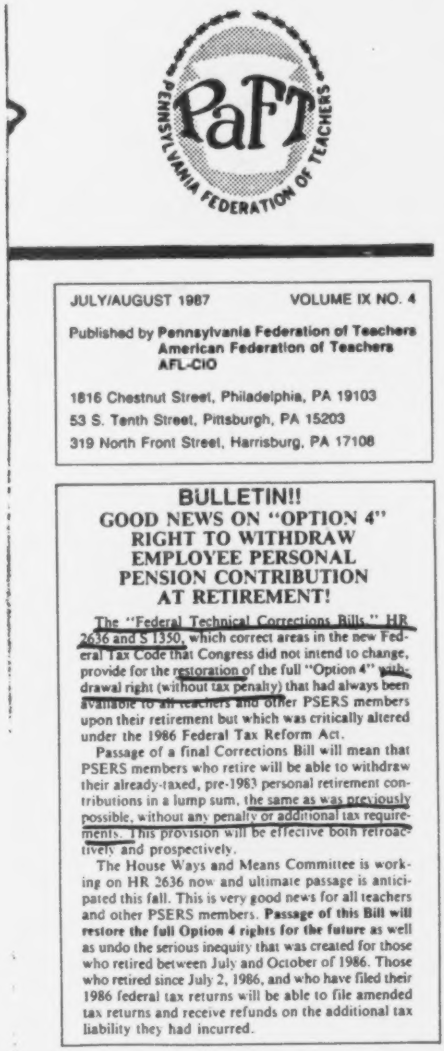
This will rectify a gross inequity which would have taxed already taxed personal retirement contributions when withdrawn in a lump sum.

Very truly yours,

THEODORE W. JENTSCH
Professor, Sociology
Kutztown University
Kutztown, Pennsylvania 19530

27 July 1987

cc Rep. Gus Yatron



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AFL-CIO**

1816 Chestnut Street, Philadelphia, PA 19103
53 S. Tenth Street, Pittsburgh, PA 15203
319 North Front Street, Harrisburg, PA 17108

## BULLETIN!!

## GOOD NEWS ON "OPTION 4" RIGHT TO WITHDRAW EMPLOYEE PERSONAL PENSION CONTRIBUTION AT RETIREMENT!

The "Federal Technical Corrections Bills," HR 2636 and S 1350, which correct areas in the new Federal Tax Code that Congress did not intend to change, provide for the restoration of the full "Option 4" withdrawal right (without tax penalty) that had always been available to all teachers and other PSERS members upon their retirement but which was critically altered under the 1986 Federal Tax Reform Act.

Passage of a final Corrections Bill will mean that PSERS members who retire will be able to withdraw their already-taxed, pre-1983 personal retirement contributions in a lump sum, the same as was previously possible, without any penalty or additional tax requirements. This provision will be effective both retroactively and prospectively.

The House Ways and Means Committee is working on HR 2636 now and ultimate passage is anticipated this fall. This is very good news for all teachers and other PSERS members. **Passage of this Bill will restore the full Option 4 rights for the future** as well as undo the serious inequity that was created for those who retired between July and October of 1986. Those who retired since July 2, 1986, and who have filed their 1986 federal tax returns will be able to file amended tax returns and receive refunds on the additional tax liability they had incurred.

13 July 1987

U.S. Rep. Dan Rostenkowski, Chairman
TO: U.S. House nf Representative Ways & Means C

RE: LUMP SUM PAYMENT

I will be retiring from Civil Service employment December 1988, after working with the Pennsylvania Air National Guard for 24 years.

I understand that if I take lump sum distribution I will lose because I will wind up paying tax twice on some of my money due to the Tax Reform Act of 1986.

I also understand there are some legislative proposals to correct the unfairness of the new law. The bills are currently i the U.S. House of Repsrentatives Ways] and Means Committee of which you are the Chairman.

I would appreciate these proposls, to correct the gross unfairness, be passed.

Thanking you in advance.

Regina T. Morgan

Regina D. Morgan
3778 Allendale Cr
Pgh PA 15204

## Section 1123

P.O. Box 686
Cedar Glen, CA. 92321
June 27, 1987

The Honorable Dan Rostenkowski
U. S. House of Representatives
House Ways and Means Committee, Chairman
1102 Longworth House Office Building
Washington, D. C. 20515

Re: The Tax Reform Act of 1986 - Tax-Sheltered Annuities

Dear Sir:

I wrote to you last March 22, concerning the "technical corrections" bill that was to be passed this summer concerning the Tax Reform Act of 1986. Since it has been three months and I have not received a reply, I am writing again to learn what the current status is on the TSA's (403b).

I am a former school teacher who for 17 years used Tax Sheltered Annuities as a savings plan. I left teaching 2 years ago to pursue a new life of writing in the mountains. My TSA's were my nest egg. Now I'm faced with this 10% penalty to use my own money!

The contract I signed with the insurance companies has been *violated* by this new law. I thought it was usual to "grandfather" these types of changes. We knew up front with the IRA's that we faced a stiff penalty for early withdrawal. But after 17 years of the TSA's it seems unconscionable to change the rules now. I have 17 more years until I'm 59 1/2!

I am in contact with the California Teachers Association on this matter since it affects 1,000's of teachers.

I can understand the thinking that the new lower tax brackets will allow *some* people to withdraw *some* monies at lower rates then they originally avoided but that is no reason to penalize *all* of us. My greatest fear is bracket "creep". Every article I read says that these new tax brackets can not and will not stay at these rates very long. So with the 10% penalty, my income tax will quickly increase to a much higher rate then when I sheltered the monies! I understand that there is a *cap on the capital gains tax and I am pleading that that also be done to TSA's* if you cannot "grandfather" in the new penalties.

I also understand that one reason that this penalty was added was to discourage short term investment. Then I suggest that the penalty be imposed if the TSA is held fewer then 5 or 10 years. Say a 10% penalty for less then 5 years and a 5% penalty for less then 10 years.

I would appreciate a reply from you as to the status of this matter in the "technical corrections" bill. Is it being addressed and what are the specific new proposals? I am also interested in coming to Washington to visit friends and I would like to coordinate my trip to coincide with the hearings on this matter. Do you have dates set as yet as to when this matter will be debated?

Sincerely,

Mary C. Barlow
Mary C. Barlow

FAIR

FUND FOR ASSURING AN INDEPENDENT RETIREMENT

Vincent R. Sombrotto, *Chairman*
Sandra Sue Adams-Choate, *Secretary*

**Member Organizations**

American Federation of Government Employees
American Foreign Service Association
American Postal Workers Union
Epsilon Sigma Phi
Federal Executives and Professional Association
Federal Managers Association
Federally Employed Women
Graphic Communications International Union
International Federation of Professional and Technical Engineers
International Union of Operating Engineers
Military Sea Transport Union SIU
National Association of Air Traffic Specialists
National Association of ASCS County Office Employees
National Association of Federal Veterinarians
National Association of Government Employees
National Association of Letter Carriers
National Association of Postal Supervisors
National Association of Postmasters of the United States
National Association of Retired Federal Employees
National Federation of Federal Employees
National Labor Relations Board Union
National League of Postmasters of the United States
National Rural Letter Carriers Association
National Treasury Employees Union
Organization of Professional Employees of the Department of Agriculture
Public Employee Department (AFL-CIO)
Service Employees International Union
United States Air Traffic Controllers Organization

July 17, 1987

Honorable Dan Rostenkowski, Chairman
House Ways and Means Committee
1100 Longworth House Office Building
Washington, D.C. 20515

Dear Chairman Rostenkowski:

I am writing you as Chairman of FAIR, Fund for Assuring An Independent Retirement, a coalition of 28 federal and postal organizations representing 4.5 million active and retired federal employees. I wish to express the coalition's concern regarding the 10% tax on lump sum withdrawals from Civil Service Retirement System for those retiring before 55.

Sec. 1123 of last year's Tax Reform Act added a 10% additional tax on early distribution from qualified retirement plans. Subsection (t) (2) (A) (v) will allow most federal employees to avoid the 10% tax since they are usually at least 55 years of age when they retire.

There are other classes of federal employees, however, who are allowed to retire earlier:

1) those whose jobs have been determined by Congress to be so stressful that they may fully retire at age 50; and

2) those who, because of budgetary constraints, have been involuntarily separated from their job and choose early retirement.

Unlike those in the private sector, who when confronted with the 10% penalty, may "rollover" their lump sum into an IRA, there is simply no way for federal employees who retire before age 55 to avoid the tax.

We understand that at least one of the underlying policies for the 10% penalty was to discourage using the lump sum for other than retirement purposes. This argument doesn't really fit when one looks at the involuntarily separated group - they could very well need the money to re-train,

100 INDIANA AVENUE, N.W., ROOM 813 • WASHINGTON, D.C. 20001 • (202) 393-4695

to try to start a new career.

For the other group, those special classes who can retire at age 50, allowing them to rollover the money means that they do keep it for retirement purposes. The policy goal would be met.

In conversation with your staff, it appears that it was not common knowledge that federal employees are not able to "rollover" their lump sum retirement money. We urge you to correct this in the Technical Corrections bill presently before your committee.

Sincerely,

Vincent R. Sombrotto

VINCENT R. SOMBROTTO
CHAIRMAN, FAIR

July 17, 1987

## STATEMENT ON BEHALF OF MARATHON OIL COMPANY

Re: Proposed Amendment to H.R. 2636 to Modify Additional Tax on Early Distributions by a Pension Plan

This statement is submitted on behalf of Marathon Oil Company ("Marathon") for inclusion in the record of comments on H.R. 2636, the proposed Technical Corrections Act of 1987.

The Tax Reform Act of 1986 (the "1986 Act") imposes a 10% penalty tax on so-called "early distributions" from a qualified retirement plan which are made in taxable years beginning after December 31, 1986. Subject to a series of exceptions, an early distribution is one which is made before the recipient attains age 59½. One of these exceptions (the "early retirement" exception) applies where an employee, who has attained age 55, is thereafter separated from service and meets the requirements for early retirement under the qualified plan (section 72(t)(2)(A)(v) of the Code). Some employees who would qualify for this "early retirement" exception but for the fact that they retired before reaching the age 55 may nevertheless avoid the penalty tax if they meet either one of two limited transition rules (described more fully below) contained in the 1986 Act.

The imposition of an age limitation on the early retirement exception discriminates against those employees who participate in plans permitting early retirement prior to age 55 and Congress should at an appropriate time either delete the age limitation or apply the age limitation to the date on which benefits are received rather than to the date on which the employee retires. Moreover, as explained more fully below, the age limitation is particularly unfair to certain employees who retired before the date of enactment of the 1986 Act. To remedy this unfair and retroactive application of the penalty tax, a provision should be included in H.R. 2636 exempting from the penalty tax any distribution to certain employees who retired before August 16, 1986 (the date of final Conference Committee action with respect to the 1986 Act) pursuant to the early retirement provisions of a plan whether or not the individual had attained age 55 on the date he or she retired.

Application of Penalty Tax. As noted above, the "early retirement" exception to the penalty tax does not apply unless the employee has attained age 55 on or before the date of retirement. Section 1123(d)(3) of the 1986 Act exempts from the penalty tax distributions to employees who, as of March 1, 1986, had retired and were separated from service (whether or not they had attained age 55) and had commenced receiving benefits pursuant to a written election designating a specific schedule of benefit payments. Section 1124(a) of the 1986 Act contains a second transition rule under which the penalty tax does not apply to lump-sum distributions made after December 31, 1986 and before March 15, 1987, but only if the employee separated from service during 1986 and agrees to treat the distribution as having been made in 1987.

The combined effect of these three rules is that an employee who retired, pursuant to the early retirement provisions of a plan, before reaching age 55 and before the date of enactment of the 1986 Act will be subject to the penalty tax on all post-1986 distributions unless either another exception applies (such as that for joint and survivor annuities) or the distribution qualifies under the lump-sum distributions transition rule of section 1124(a) of the 1986 Act. As explained below, this unfairly subjects certain retirees to the penalty tax on a retroactive basis.

Reasons For Change. The unfair manner in which the penalty tax can be applied is aptly illustrated by the situation faced by 134 employees, aged 50 through 54, of Marathon who elected to take early retirement on July 1, 1986 pursuant to the terms of qualified retirement plans maintained by Marathon. While each of these employees was entitled to take their entire accrued benefit in the defined benefit plan as a lump sum during July of 1986, each elected to transfer that benefit, via a taxfree "rollover", to a defined contribution plan (the "Thrift Plan") maintained by Marathon. Under the terms of the Thrift Plan, these retirees may elect from a broad range of options for having their benefits distributed to them. Under the Thrift Plan, these 134 employees were entitled to average annual annuities (including the amounts attributable to the rollover) ranging from $17,632 to $35,196. Most of these retirees had undistributed benefits as of January 1, 1987.

However, even though these individuals retired before the Conference Committee completed action on the 1986 Act, and even though they could have avoided the early distribution penalty tax by taking lump sum distributions in July 1986, they will now be subject to that tax unless they either defer all distributions until they reach 59½ (or die or are disabled) or elect to receive their benefits as a qualified annuity under section 72(t)(2)(A)(iv) of the Code. This is unfair for several reasons. First, because these employees made a rollover in July, 1986 (before the Conference Committee completed action on the 1986 Act), they were not eligible for a lump sum distribution from the Thrift Plan in 1986 that would be subject to 10-year forward averaging. Thus, these employees could not take advantage of the second transition rule to avoid the 10% penalty. Second, as noted, had such employees elected the lump sum distribution option in July 1986, instead of making a rollover to another qualified plan, they would not have been liable for the penalty tax. There is no discernable tax policy reason why these employees should be subject to the penalty tax by reason of their choice to take their benefits in one particular form. Third, at the time (July 1, 1986) these employees had to elect to take early retirement (and make their benefit distributions decisions), the Conference Committee had not yet concluded action on the 1986 Act. These employees should not be held to a standard requiring them to have anticipated that the Conference Committee would apply the penalty tax retroactively to employees who had already retired. This is particularly true given the statements that had theretofore been made repeatedly by the Administration and by Congressional leaders concerning the goal of avoiding retroactivity (at least in nonabusive cases) in structuring the 1986 Act.

Proposed Amendment. For these reasons, Congress should act to prevent the application of the early distribution penalty tax to those who retired before the completion of Conference Committee action on the 1986 Act. The present transition rule (which requires retirement as of March 1, 1986 and the receipt of specific pattern of benefits) is too strict as a matter of policy. Therefore, section 1123(e) of the 1986 Act should be amended by adding the following new paragraph at the end thereof:

> "(5) Certain Early Retirements. The amendments made by this section shall not apply to any distributions to an employee from a plan maintained by an employer if such employee separated from service after attaining age 50 and before August 16, 1986 on account of early retirement pursuant to the terms of any plan maintained by such employer, but only if such employee was eligible to elect under such plan to have his entire accrued benefit distributed, on or before December 31, 1986, as a lump sum."

Respectfully submitted,

Donald V. Moorehead

Donald V. Moorehead
Patton, Boggs & Blow
2550 M Street, N.W.
Washington, D.C. 20037
(202) 457-5212

MICHAEL G. OXLEY
4TH DISTRICT OHIO

COMMITTEE ON
ENERGY AND COMMERCE

SELECT COMMITTEE ON
NARCOTICS ABUSE AND CONTROL

CONGRESSIONAL RURAL CAUCUS

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July 16, 1987

Honorable Dan Rostenkowski
Chairman
Committee on Ways and Means
1102 Longworth HOB
Washington, D.C. 20515

Dear Dan:

These are my written comments about the Tax Reform Act of 1986 and H.R. 2636, the Technical Corrections Act of 1987.

As you know, many of us voted for last year's bill recognizing that it was not perfect. At the time the bill was adopted, my major concern was about the three-year recovery provision. It seemed inequitable then, and still does now, that we should retroactively impose a new formula on retirees. I am very disappointed that this issue is not addressed by HR 2636. At the very least, the effective date for that new rule should have been January 1, 1987 or the date of enactment. I recommend that you incorporate one of those dates into HR 2636.

At the time I voted for the tax bill I was unaware that a number of my constituents would be adversely affected by a technicality. I am referring to the 10% penalty tax on early distributions from qualified retirement plans. The unfair manner in which the penalty tax can be applied is illustrated by the situation faced the 131 employees, aged 50 to 54, of Marathon Oil Company, headquartered in my hometown of Findlay, Ohio, who elected to take early retirement on July 1, 1986 pursuant to the terms of qualified retirement plans maintained by Marathon.

Because of industry problems, Marathon was offering early retirement incentives to a number of employees. Under the company's defined benefit pension plan, these 131 employees were entitled to average annual annuities ranging from $17,632 to $35,196. While each of these employees was entitled to take their entire accrued benefit in the plan as a lump sum during 1986, each elected to transfer that benefit, via a tax-free rollover, to a defined contribution plan (the Thrift Plan) maintained by Marathon. Under the terms of the Thrift Plan, these retirees may elect from a broad range of distribution options. Most of the retirees had undistributed benefits as of January 1, 1987.

The penalty provision is unfair to these persons for two reasons. First, at the time they had to make the decision to take early retirement (July 1, 1986) the conference committee had not yet concluded action on the tax bill. How could they have anticipated they would be subject to a retroactive provision? Second, the arbitrary age exception (those between 55 and 59 1/2 being exempt from penalty) has persons who once worked next to each other for the same number of years being treated under different sets of rules because of their ages. A number of my Marathon retired friends between the ages of 50 and 54 have contacted me to inquire why they are being treated differently from their former co-workers who are a few months or years older. I have no reasonable answer for them.

I believe the 1986 act should be amended to remove the early distribution penalty for anyone who had attained the age 50 and retired before October 22, 1986. It was a poorly timed coincidence that Marathon and perhaps other oil-industry companies were offering early retirement options at the same time the tax committees were changing the laws. It would only be fair to treat these retirees in an equitable manner.

Sincerely,

Michael G. Oxley, M.C.
Fourth Ohio District

**CHARLES PASHAYAN, JR.**
17TH DISTRICT, CALIFORNIA

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COMMITTEE ON
INTERIOR AND INSULAR
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**CONGRESS OF THE UNITED STATES**
**HOUSE OF REPRESENTATIVES**

July 17, 1987

The Honorable Dan Rostenkowski, III
Chairman
Committee on Ways and Means
U.S. House of Representatives
Washington, D.C. 20515

Dear Mr. Chairman:

I urge you to amend the Technical Corrections Act to relieve from the 10 percent early withdrawal penalty beneficiaries of pension plans that were in the process of being terminated when the President signed tax reform into law. The relief is necessary to prevent the beneficiaries from suffering unfairly because of Internal Revenue Service delays.

A small newspaper in my district belongs to the Scripps League pension fund. In 1985, the Scripps League decided to change its employee retirement plan. To accomplish this end it planned to terminate the existing pension fund and establish a new one. Employers who belong to the fund informed employees that they would receive their share of the fund and that they would have the option of investing their share in the new pension fund.

Scripps League applied for the IRS's approval for the termination of the existing fund. Had the IRS approved the termination in 1985 or 1986, employees who chose not to reinvest their pension fund proceeds in the new fund would not have been liable for the early withdrawal penalty. Tax reform changed the law to impose a 10 percent penalty on all early withdrawals. As a result, when the IRS finally approved the termination in 1987 employees who chose not to reinvest their funds became liable for the 10 percent penalty.

Imposing the 10 percent penalty is unfair to both employer and employees. The employer could not have anticipated the change in law when it made the business decision to terminate the existing fund and inform employees of their options. The employees who exercise their option to keep their pension proceeds should not be penalized for the IRS's delays.

Many employees scattered throughout the country probably find themselves in a similar situation. They all deserve relief from the early withdrawal penalty. Ascertaining when in 1986 the employer should have anticipated the broader application of the early withdrawal penalty would be impossible. Consequently, I urge you to extend relief to all pension funds with termination applications pending before the IRS when the President signed tax reform into law.

Thank you for your attention to this matter.

Sincerely yours,

Charles Pashayan Jr.

Member of Congress

Section 1131

JOHN W. BAGWILL, JR., *President*
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BARRY H. SCHAFFER, *Vice President*
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PATRICK J. SULLIVAN, *Secretary*

**FINANCIAL INSTITUTIONS RETIREMENT FUND**

■ 5 CORPORATE PARK DRIVE ■ P.O. BOX 847 ■ WHITE PLAINS, N.Y. 10604 914-694-1300 ■

July 15, 1987

Robert J. Leonard, Esq.
Chief Counsel
Ways and Means Committee
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D. C. 20515

Re: Technical Corrections Act of 1987

Dear Mr. Leonard:

In response to Chairman Rostenkowski's invitation for comments on the proposed Technical Corrections Act of 1987 (H.R. 2636, S. 1350), as introduced on June 10, 1987, (the "TCA"), I am writing to recommend that the bill include a technical correction in Section 1131 of the TCA, relating to adjustments to the deduction limitations under Section 404 of the Internal Revenue Code of 1986 (the "Code"). The requested correction relates to the application of Section 404 in the context of multiple employer plans described in Section 413(c) of the Code.

The Financial Institutions Retirement Fund (the "Fund") is a Section 413(c) multiple employer plan. The Fund was established in 1943 to provide retirement and certain other benefits for the eligible employees of the Federal Home Loan Banks, and other financial institutions and those organizations serving them.

Under Section 413(c)(6) of the Code, the deductible limits for Section 413(c) plans are calculated by aggregating all participants of the plan and treating them as if employed by a single employer, with the consequence that all employers contributing to the plan are aggregated and treated as a single employer. When a Section 413(c) plan is subject to the full funding limitation imposed under Section 404 of the Code, no deductible contributions to the plan may be made by any employer and a 10% excise tax will be imposed on any nondeductible contributions which might be made. This effectively precludes the Fund from collecting contributions from certain employers who have only recently begun participating in the Fund who should otherwise be required to contribute to fund the liabilities attributable to their employees, allowing these employers to provide plan benefits for their employees at the expense of those employers whose participation in the Fund over the long term has contributed to the fully funded status of the plan. This is also a serious deterrent for any new employers who might otherwise wish to provide retirement benefits to their employees by joining the Fund.

I have enclosed a position paper describing the issue in more detail, as well as proposed statutory language. We believe that Congress did not intend to adversely impact Section 413(c) multiple employer plans, and respectfully request your consideration in correcting the technical problem.

We would like to meet with you and others on the Ways and Means Committee staff at your convenience to discuss the issue and to respond to any questions you may have. We will be calling your office to arrange for such a meeting.

Respectfully submitted,

John W. Bagwell, Jr.

John W. Bagwill, Jr.
President
Financial Institutions
Retirement Fund

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## Impact of Full Funding on Financial Institutions Retirement Fund

### Background

In 1943, the Federal Home Loan Banks and a group of savings and loan institutions established a not-for-profit organization, the Financial Institutions Retirement Fund, which designs and administers benefit plans for employees in the thrift industry. The organization administers two basic programs, the Financial Institutions Retirement Fund (the "Retirement Fund") and the Financial Institutions Thrift Plan.

The Retirement Fund is a multiple employer, single defined benefit plan under section 413(c) of the Internal Revenue Code which allows participating employers to design a normal retirement income for employees at age 65 in accordance with the benefit formula adopted by the employer. In addition to basic normal and early retirement benefits, there are other options available such as death and disability coverage, increased early retirement incomes and post retirement cost-of-living adjustments. The Retirement Fund provides coverage for over 26,000 active employees and 6,600 retirees of nearly 500 employers. The Retirement Fund serves primarily smaller employers for which the costs of a separate plan would present an impediment to the establishment of a pension plan. Nearly half of the employers participating in the Fund have 20 or fewer employees and three-fourth have 50 or fewer employees. The Retirement Fund's economies of scale result in reduced administrative expenses which permit many small employers to maintain defined benefit plans for their employees that might otherwise be too costly or administratively burdensome to maintain on an individual employer basis.

As a multiple employer plan, the Retirement Fund is viewed as a single plan for purposes of the annual limitation on deductible contributions. Under applicable law, no tax-deductible contributions may be made to a qualified plan when the plan is in full funding and any nondeductible contributions which are made will be subject to a 10 percent excise tax. Due to favorable investment experience, the Retirement Fund, when viewed as a single plan, is in full funding for the first time for the plan year commencing on July 1, 1987. There is a 50 percent probability that the Retirement Fund will remain in full funding for a period of 6 years.

Issues

Although the Fund is in full funding, the plans of certain participating Retirement Fund employers, when viewed separately, might not be in full funding. Nevertheless, such an employer would not be able to make a tax-deductible contribution to the Retirement Fund and thus will not be funding the employer's share of the Fund's actuarial liability.

Prior to the Tax Reform Act of 1986, a participating employer could have made a non-deductible contribution to the Retirement Fund. The 10 percent excise tax on non-deductible contributions imposed by the 1986 Act now effectively precludes the Retirement Fund from collecting such contributions.

These limitations prevent the Retirement Fund from properly serving the thrift industry and the Fund has actually suspended all contributions. The Retirement Fund will not be able to take contributions from employers whose plans, when viewed separately, are not in full funding. Typically, these would be employers who recently have joined the Retirement Fund, or have improved the level of benefits under the Retirement Fund. In addition, new employers will be excluded from the Retirement Fund by their inability to make tax-deductible contributions.

Proposed Solution:

Section 413(c) should be amended to permit a multiple employer plan to irrevocably elect to apply the annual limitation on deductible contributions on an employer-by-employer basis. This election would only be available when the procedures of the plan permit the determination of separate funding requirements and those requirements form the basis for actual contributions. A conforming adjustment to the minimum funding standard would also result from the election. However, a multiple employer plan making the election would continue to be treated as a single plan for all other purposes as under present law.

Discussion:

The Retirement Fund, due to the special nature of the services it provides and its economies of scale, enables many small employers in the thrift industry to provide retirement programs for their employees when it would be too costly to do otherwise. The Retirement Fund contains many features such as portability and improved benefit security which support the policies embodied in recently enacted and proposed pension legislation. The proposed amendment will permit (1) new employers to participate in the Retirement Fund while the Retirement Fund is in full funding by virtue of contributions by others and (2) a more equitable allocation of cost of benefits among participating Retirement Fund employers. Under the amendment, when the plan is not in full funding, employers who would be in full funding if viewed separately would not be permitted to make deductible contributions.

### Amendment Relating to Multiple Employer Plans

Viz:

Section 413(c)(4) is amended by striking "The minimum" and inserting in lieu thereof: "Except as provided in paragraph (7), the minimum"

Section 413(c)(6) is amended by striking "Each applicable" and inserting in lieu thereof: "Except as provided in paragraph (7), each applicable"

Section 413(c) is amended by adding at the end thereof the following new paragraph:

"(7) Election.--In the case of any 'qualified electing multiple employer plan,'

(A) each applicable limitation provided by section 404(a) shall be determined

(i) by treating (solely for purposes of section 404(a)) each employer's participation in the plan as the establishment and maintenance of a separate defined benefit plan described in section 401(a) covering only its own employees, and

(ii) by allocating to each such separate plan a share of assets and liabilities determined by applying the method specified by the planfor determining the amount of plan assets and liabilities which would be transferred to a successor plan of a withdrawing employer, and

(B) the minimum funding standard provided by section 412 shall be determined by allowing as a credit under section 412(b)(3) the amount of any charges less credits to the funding standard account under section 412(b) with respect to which a deduction would be disallowed under section 404(a) by reason of the application of subparagraph (A) of this paragraph.

(C) For purposes of this paragraph, a 'qualified electing multiple employer plan' is any plan to which this subsection applies and which has elected the application of this paragraph in the form and manner provided for by the Secretary.

The election provided by this paragraph shall be revoked only with the consent of the Secretary."

Effective date.--The election provided under section 413(c)(7) of the Internal Revenue Code of 1986 shall be available with respect to the plan year which includes the date of enactment of this Act or any subsequent plan year.

## Section 1151

ROBERT T. MATSUI
THIRD DISTRICT, CALIFORNIA

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July 9,1987

The Honorable Dan Rostenkowski
Chairman, Committee on Ways and Means
2111 Rayburn House Office Building
Washington, D.C. 20515

Dear Mr. Chairman:

This responds to your request for suggestion for additional technical corrections. Section 125(c)(2)(C) was adopted as a special provision in the Tax Reform Act of 1986 to allow employees of educational organizations to pre-fund post-retirement life insurance coverage. It is not clear however, how the new employee benefit nondiscrimination rules under Section 89 might be applied to such a program. The application of the nondiscrimination rules to a Section 125(c)(2)(C) benefit program is uncertain because the unique character of the program was not specifically taken into account during the development of the nondiscrimination rules.

In order clarify the applicability of the nondiscrimination rules to Section 125(c)(2)(C), a technical correction that specifically recognizes the unique character of a post-retirement life insurance benefit is needed. Such a rule would acknowledge that, because of the very restrictive nature of a Section 125(c)(2)(C) benefit program (e.g., it is offered only on a voluntary basis through the cafeteria plan; it creates no current cash value benefit accessible to the employee; it is limited to employees of educational organizations; etc.) the full arsenal of nondiscrimination rules applicable under Section 89 is not needed.

Attached for your consideration are the proposed technical changes to Section 125.

Very truly yours,

Bob

ROBERT T. MATSUI
Member of Congress

THIS STATIONERY PRINTED ON PAPER MADE WITH RECYCLED FIBERS

**Clarification of I.R.C. §89 and I.R.C. §125(c)(2)(C)**

1. Proposed technical correction:

In lieu of I.R.C. §125(c)(2)(C), substitute the following (new language is underlined):

> (C) Exception for certain plans maintained by educational institutions. -- Subparagraph (A) shall not apply to a plan maintained by an educational organization described in section 170(b)(1)((A)(ii) to the extent of amounts which a covered employee may elect to have the employer pay as contributions for post-retirement group life insurance if --
>
> (i) all contributions for such insurance must be made before retirement,
>
> (ii) all contributions result in a vested post-retirement life insurance benefit proportionate to the employee's participation in the plan,
>
> (iii) the contributions in any year for an employee are not greater than that which would be necessary to fund the post-retirement life insurance benefit for such employee on a level premium basis (taking into account prior contributions and guaranteed accumulations), and
>
> (iv) such life insurance does not have a cash surrender value at any time.
>
> For purposes of section 79, any life insurance described in the preceding sentence shall be treated as group-term life insurance. Furthermore, the provisions of section 89 shall be applied when the contributions are made to the plan (not when the benefits are received); for purposes of applying sections 89(d) and (e), the benefit (expressed as dollars of projected post-retirement life insurance coverage) shall be valued under the special rules applicable to group-term life insurance; section 89(e) shall be applied by taking into account only those employees covered by the plan if at least 80 percent of such employees are not highly compensated; for purposes of applying section 89(a), the amount of the employee's excess benefit for any year shall be the amount by which the contribution made on behalf of such employee in such year exceeds the amount necessary to fund the highest permitted benefit (expressed as dollars of projected coverage) on a level premium basis (taking into account prior contributions and guaranteed accumulations); and, for purposes of section 89, a plan of insurance under this subparagraph shall not be considered as a plan of the same type as any plan not under this subparagraph.

Explanation:

The technical correction further defines the type of post-retirement life insurance plan intended to be covered by Section 125(c)(2)(C). As the contributions are made for an employee before retirement, the employee must have a vested benefit proportionate to the employee's participation in the plan, taking into account prior contributions and the number of years to retirement. Also, the contributions funding the post-retirement benefit in any year cannot be greater than that which would be necessary to fund the benefit on a level premium basis (taking into account prior contributions and guaranteed accumulations).

The statutory structure and placement of the Section 125(c)(2)(C) benefit recognizes the dual nature of the benefit as a deferred employee benefit -- a deferred compensation benefit as well as group-term life insurance. Although testing for discrimination within an ordinary group-term life insurance plan is done at the time the benefit is received, this can lead to arbitrary results in the case of a Section 125(c)(2)(C) benefit plan because the benefit is actually purchased for the employee at an earlier date (as contributions are made) than when it is received. Thus, the technical correction clarifies that a Section 125(c)(2)(C) benefit plan will be tested under Section 89 nondiscrimination rules, and an employee will be taxed on excess benefits, when contributions are made rather than when the actual benefits are received.

Despite the special rule for when the nondiscrimination tests under Section 89 will be applied, the technical correction makes it clear that, generally, the Section 125(c)(2)(C) benefit will be treated as group-term life insurance for purposes of determining the employer-provided benefit and applying the tests under Section 89, with certain modification to accommodate the unique character of the benefit. For purposes of applying the nondiscrimination tests (Section 89(d) and (e)), the value of the Section 125(c)(2)(C) benefit (expressed as dollars of projected post-retirement life insurance coverage) taken into account will be adjusted for a uniform age (as under Section 89(g)(3)(C)) -- that is, the amount taken into account for any employee shall be based on the cost of insurance determined under Section 79(c) for an employee who is age 40. Likewise, the amount will be adjusted depending on the compensation of the employee (as under Section 89(j)(4)) by multiplying the amount by a fraction the numerator of which is a uniform amount for all Section 125(c)(2)(C) benefit plans and the denominator of which is the employee's compensation (see H. Rept. 99-841, 99th Cong., 2d Sess. II-514). However, for purposes of applying the benefit requirements under Section 89(e), the average employer-provided benefit can be computed by taking into account only those employees covered by the plan *if* at least 80 percent of all covered employees are not highly compensated. Also, although the Section 125(c)(2)(C) benefit is treated as group-term life insurance for purposes of valuing the benefit, a Section 125(c)(3)(C) benefit plan is not a plan of the same type as any plan not described under Section 125(c)(3)(C).

Any excess benefit with respect to coverage for a highly compensated employee under a Section 125(c)(2)(C) plan also will be determined in a manner similar to that used for group-term life insurance plans. Specifically, the amount to be taken into account will be the cost of such excess benefit (expressed as dollars of such coverage). That is, it will be the amount by which the contribution made in any year on behalf of a highly compensated employee exceeds the amount necessary to fund the highest permitted benefit for such employee, expressed as dollars of coverage, on a level premium basis (taking into account prior contributions and guaranteed accumulations).

2. Proposed technical correction:

Modify I.R.C. §125(e)(2)(A) by inserting after "79" and before ", and":

> (and, for purposes of applying subsection (b)(2), such qualified benefit shall be valued by taking into account sections 89(g)(3)(C) and 89(j)(4))

Explanation:

The technical correction clarifies that for purposes of applying the cafeteria plan nondiscrimination requirements -- particularly the concentration test under Section 125(b)(2) -- the value of group-term life insurance as a qualified benefit should be adjusted for a uniform age (as under Section 89(g)(3)(C)) and depending on compensation (as under Section 89(j)(4)). If the cafeteria plan rules were not so clarified, a group-term life insurance benefit within a cafeteria plan could cause the plan to fail the cafeteria plan nondiscrimination requirements, even though the group-term life insurance benefit would pass the general nondiscrimination rules of Section 89 if it were an independent plan.

## Section 1172

### JOINT STATEMENT OF THOMAS A. JORGENSEN AND ELAINE K. CHURCH BEFORE THE COMMITTEE ON WAY AND MEANS, U.S. HOUSE OF REPRESENTATIVES

This statement is submitted jointly by Thomas A. Jorgensen, an attorney with the law firm of Calfee, Halter & Griswold in Cleveland, Ohio, and Elaine K. Church, a senior manager with the national accounting firm of Price Waterhouse. We appreciate the opportunity to provide written comments to your Committee on H.R. 2636, the Technical Corrections Act of 1987 and to address an important issue related to Employee Stock Ownership Plans (ESOPs).

Since 1973, Congress has supported the development and growth of ESOPs through a series of legislative initiatives. Congress viewed ESOPs as a bold and innovative method of strengthening the free enterprise system and solving the dual problems of securing capital funds necessary for corporate growth and of bringing about stock ownership for a large number of corporate employees.

The Deficit Reduction Act of 1984 further expanded the tax incentives for establishing ESOPs by adding Section 1042 to the Code. Through Section 1042. Congress sought to encourage closely-held corporations to establish ESOPs by providing certain taxpayers with the ability to defer the recognition of any gain realized on the sale of employer securities to an ESOP. To realize the Congressional intent underlying Section 1042, the Code needs to be amended.

We urge that H.R. 2636, now before the Committee, include a provision amending Section 409(n) of the Code to provide that the allocation restrictions be applied separately to each unrelated seller of employer securities. This would eliminate the unnecessarily punitive position taken by the Treasury Department that the allocation restrictions apply to all securities acquired by the ESOP from unrelated sellers in a Section 1042 transaction.

## I. BACKGROUND

Section 1042 of the Code generally permits an individual who sells qualifying employer securities to an ESOP to defer recognition of gain realized on the sale, provided certain conditions are met. To ensure that the transaction actually benefits a broad group of employees, Section 1042(b), as orginally enacted, denied nonrecognition treatment if the ESOP allocated securities acquired in a Section 1042 transaction to or for the benefit of (1) the seller, (2) certain family members of the seller, or (3) any 25 percent shareholder.

Because of the three-year statute of limitations typically applicable to an individual's tax return, it was determined that denying Section 1042 nonrecognition treatment to the seller was an ineffective sanction. Once the statute had expired with respect to the seller's return, no enforceable penalty would apply if the ESOP allocated the Section 1042 securities to the prohibited participants. To remedy this situation, the Tax Reform Act of 1986 (the "Act") replaced Section 1042(b) with new Section 409(n). Section 409(n) generally provides that an allocation of Section 1042 securities to prohibited individuals will (1) be treated as a distribution to these individuals and (2) be subject to the 50 percent excise tax imposed by Section 4979A.

## II. INTERPRETATIONS OF THE ALLOCATION RESTRICTIONS PRIOR TO THE TAX REFORM ACT OF 1986

The scope of these restrictions on the allocation of securities acquired in a Section 1042 transaction has never been clearly articulated. Section 1042(b)(3) orginally restricted allocations of "assets...attributable to employer securities... acquired by the plan described in paragraph (1) [of Section

1042]." This language, which was not addressed in the Senate Finance Committee Report (S. Rep. 98-169, 98th Cong. 2nd Sess. 1183), arguably would have totally precluded prohibited individuals from participating in an ESOP that is a party to a Section 1042 transaction (including participation in a pretransaction period). However, the General Explanation of the Deficit Reduction Act of 1984 suggests that this prohibition was not intended. The General Explanation states, at page 897, that the allocation restrictions extend merely to "assets attributable to the qualified securities involved in the nonrecognition transaction." Thus, where the allocation restrictions would apply to the seller and family members, they appeared merely to restrict the allocation of the securities acquired from the seller in the Section 1042 transaction.

The General Explanation appeared also to suggest, therefore, that if there were a series of Section 1042 transactions involving unrelated sellers, the allocation restrictions would apply separately to the securities acquired in each transaction. Assume, for example, that in two Section 1042 transactions involving unrelated sellers, the allocation restrictions would apply separately to the securities acquired in each transaction. Assume also that $15 million of securities are acquired from Seller A in year one and $1 million of securities from Seller B in year three. Assume further that A and B are unrelated and that A, B and their family members are not twenty-five percent shareholders. In that case, the General Explanation suggests that Seller A (and family) are precluded from receiving an allocation of any of the $15 million of securities acquired in the sale by A, but are eligible to participate in the allocation of the $1 million of securities in the sale by B. Similarly, B (and family) are precluded from receiving an allocation of any of the $1 million of securities acquired in the sale by B, but are eligible to participate in the allocations of the securities acquired in the sale by A.

The Treasury Department, however, took a contrary view in temporary regulations issued under Section 1042. Question and Answer 2 of Section 1.1042-1T provides that the allocation restrictions apply to every seller and family member with respect to all securities acquired in any sale (either concurrent or subsequent) to which Section 1042 applies. Under this interpretation, A (and family) could not participate in the allocation of the securities acquired from either A or B. Also, although B (and family) could participate in year one and year two allocations of securities acquired from A, they could not, by virtue of B's sale in year three, thereafter participate in further allocations of securities acquired from A. We believe this position is unnecessarily punitive.

## III. THE TAX REFORM ACT OF 1986

When the Act altered the sanctions for allocating securities to restricted individuals, the issue of the scope of the allocation restrictions resurfaced. By its terms, Section 409(n) now generally restricts the allocation of "securities acquired by the plan...in a sale to which Section 1042...applies." Also, Section 409(n)(3) provides a limited exception to the allocation restrictions for individuals otherwise affected only because they are a seller's lineal descendants. Under the exception -- "the aggregate amount allocated to the benefit of all such lineal descendants during the nonallocation period cannot exceed more than 5 percent of the employer securities (or amounts allocated in lieu thereof) held by the plan which are attributable to a sale to the plan by any person related to such descendants (within the meaning of section 267(c)(4)) in a transaction to which section 1042 applied." We understand that except for the addition of the rules under Section 409(n)(3), the Act's replacing the sanctions under Section 1042(b) with those under Section 409(n) was not intended to alter the scope and application of the allocation restrictions.

The limited exception in Section 409(n)(3) does not, of course, necessarily invalidate the temporary regulations but it does call their validity into question. Section 409(n)(3) was intended as a relief provision to allow lineal descendants to share in some portion of the securities acquired from a related party. It seems unusual for Congress to allow descendants to share in allocations from a related party if they are precluded from receiving allocations from strangers. If the proposed regulations are still valid, A (and family) generally would be precluded from receiving any securities received from A or B except that, pursuant to Section 409(n)(3), A's lineal descendants could receive allocations of securities received from A or B in an amount not to exceed 5 percent of the $15 million of securities acquired from A. B (and family) could continue to participate in allocations of securities received from A in year one or year two. However, in year three, further allocations of A's securities (and all allocations of B's securities) to A (and family) and B (and family) generally would be precluded on account of B's sale, except that, pursuant to Section 409(n)(3), B's lineal descendants could receive allocations not to exceed 5 percent of the $1 million acquired from B.

We believe that this result, like that suggested by the temporary regulations, seems unduly punitive. If A and B are unrelated, it is unnecessary to preclude A (and family) from receiving allocations of securities acquired from B or to preclude B (and family) from receiving allocations of securities acquired from A. Also, it makes little sense to allow A's lineal descendants to receive allocations of securities acquired from A or B not to exceed 5 percent of the securities acquired from A and no other securities acquired from B.

## IV. REASONS THAT THE ALLOCATION RESTRICTIONS MUST BE AMENDED

The allocation restrictions were orginally intended to preclude inappropriate tax benefits to individuals who merely changed the form of their stock ownership. Thus, for example, an individual who sells securities to an ESOP was ineligible to defer recognition of gain if those securities were then reallocated to the individual under the ESOP. This intent is not furthered by applying the allocation restrictions to separate transactions involving unrelated parties and disparate amounts. Moreover, the severity of the sanction varies indirectly with the size of the Section 1042 transaction. Thus, those taxpayers deriving the greatest tax benefit are subject to the least sanction. In our example, for instance, denying B (and family) the opportunity to share in plan allocations of the $15 million acquired from A is not warranted by the nonrecognition treatment afforded B with respect to B's subsequent sale of only $1 million of securites. In addition, application of the allocation restrictions in this fashion operates as a trap for the unwary. If, for example, B had delayed the sale of the $1 million until the $15 million of securities acquired from A were fully allocated, B (and family) clearly could share in the allocation of securities acquired from A. It is only because B engaged in a 1042 transaction before the securities acquired from A were fully allocated, that the restrictions apply to B (and family). This different result is not compelled by the timing difference.

The results are similarly skewed if the ESOP borrows to acquire securities in a Section 1042 transaction. In such a leveraged transaction, the acquired securities are allocated as the debt is repaid. Thus, in our example, if the ESOP were not leveraged and securities acquired from A were fully allocated prior to B's sale, B (and family) could participate in all allocations of such securities. If, however, the ESOP were leveraged so that debt repayment and allocations of the securities acquired from A continued after the plan acquired securities from B, B (and family) would be precluded from receiving allocations of securities acquired from A during the nonallocation period beginning with the date the plan acquired securities from B.

We understand that the position taken in the Temporary Regulations is due in large part, to concerns about "cross-allocations" where two shareholders agree to simultaneously sell their securities to an ESOP. Although shareholder A (and family) would be precluded from receiving allocations of securities acquired from A, some have argued that this restriction has no effect if they can receive allocations of securities acquired from B. This analysis seems overly simplistic. Even if A and B simultaneously sold equal amounts to the ESOP and were the only ESOP participants, applying the restrictions separately to each prohibited individual would limit each individual to an allocation equal to one-half of the allocation to which he or she would otherwise be entitled under the plan. This hardly represents a negation of the allocation restrictions. Where, as is more often the case, the shareholders sell different amounts to the ESOP at different times, and there are many completely unrelated participants in the ESOP, the position taken in the temporary regulations is even less justified.

We do recognize that in rare cases there could be cross-allocations among sellers engaging in a Section 1042 transaction. This could occur, for example, if a corporation were owned by four shareholders, each of whom had a twenty-five percent interest and all four fold their entire interests to an ESOP which covered only those four individuals. In this example, we concede that, absent the restrictive position taken in the Temporary Regulations, each shareholder could receive ESOP allocations of twenty-five percent. Thus, in effect, each shareholder would retain his or her aggregate holdings while still enjoying the tax benefits provided by Section 1042. While we agreed that this example shows that impermissible cross-allocations could occur, it is important to note that his would be a very rare situation. Attempts to preclude this abuse should not make the general rules unduly restrictive. This potential abuse would be better limited by rules that focus attention on the abusive situation. For example, the statute could preclude cross-allocation, or, like Section 412(c), permit limited allocations to lineal descendants only if no more than one-third of aggregate allocations benefit highly compensated employees.

## V. CONCLUSION

For these reasons, we believe that H.R. 2636 should include a provision amending Section 409(n) to provide that the allocation restrictions apply separately with respect to each unrelated seller of employer securities. This would permit A (and family) to fully participate in allocations of the $1 million of securities acquired from B and, pursuant to Section 409(n)(3), A's lineal descendants could also receive allocations of as much as 5 percent of the $15 million of securities acquired from A. Similarly, B (and family) would be permitted to participate fully in allocations of the $15 million of securities acquired from A and B's lineal descendants could also receive allocations of as much as 5 percent of the $1 million of securities acquired from B.

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Select Committee on Aging
Subcommittee
Health and Long-Term Care

July 16, 1987

Mr. Robert J. Leonard
Chief Tax Counsel
Committee on Ways and Means
U.S. House of Representatives
1111 Longworth HOB
Washington, D.C. 20515

Dear Mr. Leonard:

Attached please find a copy of a letter to you from Neil Chrystal. Mr. Chrystal represents my constituent, Frances G. Shoolroy, and has described in his letter the difficulties placed upon her duties as administrator of her late husband's estate through the Technical Corrections Act of 1987.

Please give careful consideration to the concerns described in Mr. Chrystal's letter with regard to this matter. I would certainly appreciate any accommodation you can make to insure that Mrs. Shoolroy's interests are not adversely affected by the provisions of the Technical Corrections Act.

Thank you very much for your attention to this matter. With best wishes, I am

Sincerely,

Ralph Regula

Ralph Regula, M.C.

RR:cdh

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VIA FEDERAL EXPRESS

July 14, 1987

Robert J. Leonard, Esq.
Chief Tax Counsel
Committee on Ways and Means
U. S. House of Representatives
1111 Longworth House Office Building
Washington, D. C. 20515-6348

Re: Comments on the Technical Corrections Act of 1987, (H.R. 2636); Effect of the Tax Reform Act of 1986 on the sale of stock to ESOPS.

Dear Mr. Leonard:

This letter describes a technical problem created by H. R. 1311 and S. 591, both of which may be incorporated into the Technical Corrections Act of 1987 (H.R. 2636 and S. 1350).

Our client, Frances O. Shoolroy, is the Personal Representative of the Estate of Ross K. Shoolroy, who died on June 27, 1987. As Personal Representative, Mrs. Shoolroy is the legal owner of a large number of shares of Ashland Oil Company, Inc. to which the provisions of Section 2057 of the Internal Revenue Code of 1986 would apply. The estate tax deduction provided by Section 2057 with respect to sales of employer securities to an ESOP would generate a considerable estate tax deduction for Mr. Shoolroy's estate. The enactment of H.R. 1311 and/or S. 591 would, however, create totally unforeseen problems for our client. As mentioned previously, these Bills may be incorporated into the Technical Corrections Act of 1987.

Mrs. Shoolroy, as Personal Representative, has been placed in an untenable position as a result of the conflict between current law and the pending legislation. As a fiduciary, Mrs. Shoolroy is under an obligation to minimize federal estate taxes, even though under the decedent's estate plan she will not directly benefit from the estate tax savings. Under current law, the federal estate tax can be reduced by selling the securities to an ESOP at a discount, and claiming the deduction allowed by Section 2057. If the estate's deduction is eliminated by the enactment of H.R. 1311 and/or S. 591, however, Mrs. Shoolroy may be liable to the residuary beneficiaries under the decedent's will for breach of fiduciary duty in selling the securities at a discount. If Mrs. Shoolroy does not sell the securities immediately, however, and thereby loses the benefit of any effective date relief which might be provided under H.R. 1311 and/or S. 591, she may be held accountable for loss of the estate tax deduction.

Finally, in this particular situation, there will be an ancillary benefit to allowing the estate to claim the deduction provided by Section 2057. The ESOP involved will be able to purchase the securities at a discount, thereby providing greater benefits to the employees it covers.

In summary, then, the conflict between current law and the provisions of H.R. 1311 and S. 591 not only place the estate's Personal Representative in an untenable position, but also adversely affect both the estate and the ESOP.

Your consideration of these comments will be greatly appreciated.

Sincerely,

Neil R.Chrystal

## Section 1173

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July 21, 1987

Mr. Robert J. Leonard, Chief Counsel
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Dear Mr. Leonard:

I am writing about certain provisions in the Technical Corrections Bill of 1987 (H.R. 2636) ("TCB '87") that would appear to have unintended and adverse consequences for one of our clients and for other persons in similar circumstances.

The provisions in question appear in Section 111B(h) of the TCB '87, which deals with Section 133 of the Internal Revenue Code of 1986.

Section 133 provides that certain described lenders may exclude from gross income 50% of the interest received on a loan to an employer corporation or an ESOP if the proceeds of the loan are used to acquire employer securities for the ESOP.

The Tax Reform Act of 1986 ("TRA '86") amended Section 133 to extend the benefits thereof to refinancings of the types of loans covered by the Section when originally made, i.e. loans used to acquire employer securities for an ESOP. See Section 1173(b)(2) amending Section 133(b)(1). The TCB '87 places the provision concerning refinancings in a new subsection, but does not change the result of the change made by the TRA '86; namely, to extend the coverage of Section 133 to refinancings of loans of the type covered by Section 133. See Section 111B(h)(2)(A). The TCB '87 further provides that the amendments covering refinancings shall apply only to loans made to refinance a loan which was used to acquire employer's securities after May 23, 1984 (with certain qualifications not here relevant) and met the requirements of Section 133 as in effect on the later of the date on which the loan was made or July 19, 1984. See Section 111B(h)(5)(A) and (B).

We have a client ESOP that borrowed $X from a bank in 1985 and purchased 100% of the capital stock of its related employer corporation for $X + Y. The proceeds of the loan of $X was used to pay that much of the purchase price of the stock. To evidence its agreement to pay the $Y portion of the purchase price at a later date it delivered its $Y promissory note. The Bank that made the loan is entitled to exclude 50% of the interest in accordance with Section 133. For purposes of this letter it is assumed that the promissory note in the amount of $Y delivered in 1985 is a loan from the employer corporation to the ESOP for purposes of Section 133. (This assumption is arguably mandated by Sections 4975(c)(1)(B) and 4975(d) and Reg.

54.4975-7(b)(1)(ii).) No part of the interest receivable by the employer corporation pursuant to the promissory note is excludable under Section 133 because of Section 133(b)(2)(B) which provides that the term "securities acquisition loan," i.e. the type of loan covered by Section 133, does not include a loan between an ESOP and an employer corporation even though it may otherwise be a "securities acquisition loan."

Our client ESOP now proposes to refinance its indebtedness by borrowing an amount from a lender or lenders described in Section 133(a) sufficient to pay the unpaid balance of the $X bank loan and the $Y promissory note. It is clear that the portion of the refinancing related to the $X bank loan qualifies as a refinancing to which Section 133 applies. However, because of Section 111B(h)(5)(A) and (B) of TCB '87 it would appear that the portion of the refinancing related to the $Y promissory note would not qualify as a refinancing to which Section 133 applies. The problem results from the requirement that the loan being refinanced must have "met the requirements of Section 133" as in effect on the date the loan was made. In 1985 when the $Y promissory note was issued, i.e. the loan was made, it did meet the definition of a "securities acquisition loan" in that it was used to acquire employer's securities for the plan, but it was disqualified for the benefits of Section 133 by Section 133(b)(2)(B) because it was between an ESOP and an employer corporation.

The last sentence of Section 133(b)(2), added by the TRA '86, would seem to clearly indicate that it was Congress' intention that an otherwise "securities acquisition loan" that was foreclosed from the benefits of Section 133 because originally made by the employer corporation to the ESOP should not be foreclosed from such benefits when such loan was held by another lender that met the requirements of Section 133 and was not the employer corporation.

Indeed it appears to be the recorded intent that a refinancing loan should qualify under Seciton 133 (if it meets all the requirements contained in Section 133), even if the original loan did not qualify as a "securities acquisition loan" because it was a loan from an employer corporation to an ESOP. See the following from the Senate Committee Report re the TRA '86 Section 1854 (which added the last sentence to Section 133(b)(2):

> "The bill would clarify the definition of the term "securities acquisition loan" in several respects. First, the bill would make it clear that the refinancing of a loan to an ESOP after the effective date of Section 133 will qualify as a securities acquisition loan, provided that the repayment period of the original loan is not extended, and the refinanced loan otherwise satisfies the requirements of Section 133. Thus, for example, loans used to acquire employer securities after July 18, 1984, qualify for such refinancing notwithstanding that the original loan would not have qualified as a securities acquisition loan under Section 133. For example, if a purchase money obligation was utilized to acquire employer securities after July 18, 1984, the refinancing of such loan is permitted to qualify under Section 133."

It is submitted that there is no logical reason to prevent a refinancing of a loan that was a "securities acquisition loan" when made except for the fact that it was between the ESOP and the employer corporation from being covered by Section 133, and that that result is probably the unintended consequence of the language used in Section 111B(h)(5)(A) and (B) of the TCB '87.

What is needed is a change in the language of those sections by substituting for the reference to "Section 133" in Section 111B(h)(5)(A)(ii)(II) and Section 111B(h)(5)(B) "(B)ii" the following: "Section 133(b)(1) (unmodified by Section 133(b)(2))."

Yours very truly,

John T. Anderson

## COMMENTS OF PAULA J. METCALF, ATTORNEY AT LAW
1000 NBC CENTER, LINCOLN, NEBRASKA 68508
ON SEC. 111B(h) of H.R. 2636

I represent First United Bancshares, Inc. ("FUB"), a Nebraska corporation, and an Employee Stock Ownership Plan (an "ESOP") established by FUB this spring to provide retirement benefits for the employees of FUB and its subsidiaries. On June 4, 1987, the FUB ESOP borrowed approximately $1.2 million from an Omaha bank and used the money on the same date to purchase FUB stock from FUB and one of the FUB shareholders. All parties are anticipating that the bank loan will be repaid in ten equal annual installments of principal, plus interest, but because most of the bank's loans do not have terms longer than five years and because FUB already has a loan outstanding from the same Omaha bank which matures on December 31, 1991, the Loan Agreement and Promissory Note were drafted to call for annual payments of interest and one-tenth of the principal with a balloon payment of the balance due on December 31, 1991. It is therefore contemplated that the FUB ESOP loan will be extended or refinanced on December 31, 1991.

As the law presently reads, §133(b)(1)(A) of the Internal Revenue Code of 1986 includes within the definition of "securities acquisition loan" any loan to an ESOP "to the extent that the proceeds are used to acquire employer securities for the plan or are used to refinance such a loan." (One-half of the interest received by a bank with respect to a securities acquisition loan is not taxable, thereby resulting in a lower interest rate being passed on to the borrower). Other subsections of §133 impose a seven-year limit on the term of certain kinds of securities acquisition loans which are eligible for the interest exclusion. The loan made to the FUB ESOP does not fit into any of these special categories. Indeed, the seven-year limitation applies only to certain kinds of loans to corporations; no such limitation is imposed by §133 on loans made directly to an ESOP. Because of the language of §133, we were confident that the lower interest rate would prevail not only for the period of the original FUB ESOP loan, but also for the period of the anticipated extension or refinancing in December of 1991.

On June 10, 1987 (six days after the closing on the FUB ESOP loan), H.R. 2636 was introduced. §111B(h) of the bill deletes the reference to refinancing in §133(b)(1)(A) quoted above, and adds a new subsection (e) to §133. Such provision states that, for original loans and for refinancings of such loans, the interest exclusion applies only to interest accruing during the "excludable period" with respect to the original securities acquisition loan. The quoted term is later defined (with respect to loans such as FUB's which are described in subsection (b)(1)(A)), as the greater of seven years or the term of the original securities acquisition loan. Thus, if the FUB ESOP loan had originally provided for a ten-year (or even longer) term, I read H.R. 2636 as allowing the interest exclusion for the entire term of the loan. But since our loan was drafted the way it was and may therefore be refinanced in December of 1991, it would seem that H.R. 2636 would limit the availability of the interest exclusion to the first seven years of the loan.

We entered into the transaction on June 4, 1987 based on our considered opinion that the shorter term of the original loan would have no adverse effect on the applicability of the §133 interest exclusion to the full term of the loan. This was certainly our good-faith understanding of the law, and I believe it is the only reasonable reading of the clear language of §133 as it now reads. Had we known that the availability of the interest exclusion for the full term of the loan depended on specifying the longer term for the original loan, I am confident that such terms could have been negotiated.

If Congress feels that some limitation is needed on the term of ESOP loans eligible for the §133 interest exclusion, I hope that the effective date of this change in the law can be drafted so as not to penalize taxpayers such as First United Bancshares, Inc. who established and planned to finance ESOPs based on the law as it read as of the date such transactions were finalized.

## Section 1174

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August 20, 1987

Honorable Dan Rostenkowski
Chairman, Committee on Ways and Means
United States House of Representatives
Washington, D.C. 20515-1308

Re: Technical Corrections -- PAYSOPs

Dear Representative Rostenkowski:

The Tax Reform Act of 1986 amended the Internal Revenue Code by permitting PAYSOPs (tax credit ESOPs) to distribute employer securities to participants upon plan termination without regard to the 84-month restriction on distributions. The Technical Corrections Bill of 1987 (H.R.2636/S.1350) proposes to limit this exception to the 84-month rule to lump sum distributions on plan termination to those situations where the employer does not establish a successor plan. Kent Mason, the Pension Counsel for the Joint Committee on Taxation, recently stated at a Washington meeting that a successor plan would include any defined contribution plan established by the employer, without regard to when the plan was adopted.

We do not object to Congress adding a provision in the Technical Corrections Bill narrowing the exception to the 84-month rule on plan termination. However, it appears that the proposed effective date of the Technical Corrections Bill will implement the change retroactively, as if the narrower rule had been contained in the Tax Reform Act of 1986. This retroactive application will jeopardize the qualification of terminated PAYSOPs that made distributions in reliance upon the prior rule. We object to any retroactive application of the new rule since many employers have relied upon the provision in the Tax Reform Act of 1986 permitting termination of PAYSOPs and the immediate distribution of employer securities without regard to the 84-month rule.

If the proposed effective date is maintained, we request that a special transitional provision be added protecting distributions made prior to the date the Technical Corrections Bill was introduced in Congress. Thank you for your consideration in this matter.

Sincerely,

James E. Brophy, III
Charles W. Whetstine

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CONSULTANTS
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August 19, 1987

The Honorable Dan Rostenkowski
Chairman, Ways and Means Committee
U.S. House of Representatives
1102 LHOB
New Jersey and Independence Avenues, S.E.
Washington, D.C. 20515

The Honorable Lloyd M. Bentsen
Chairman, Finance Committee
U.S. Senate
205 SDOB
Constitution Avenue and First Street, N.E.
Washington, D.C. 20510

Dear Representative Rostenkowski and Senator Bentsen:

We are writing to express the deep concern of Buck Consultants and its clients about the proposed amendments in the Technical Corrections bill (H.R. 2636, S. 1350) to Section 1174 of the Tax Reform Act of 1986 (TRA'86) and an interpretation being given to these amendments that retroactively would effectively preclude a company from terminating its Tax-Credit ESOP for seven or more years. This interpretation is apparently being seriously discussed in Washington.

Buck Consultants, Inc., a leading employee benefits consulting firm, has many clients that maintain Tax-Credit ESOPs. They would be adversely affected if these amendments are adopted and regulations on these amendments adopt this interpretation and preclude termination of these plans for seven or more years. This would be an extreme breach of faith -- based on the understanding of employers and Congress when TRA'86 was enacted.

## Congressional Intent

As originally enacted, TRA'86 amended Code Section 409(d)(1) to allow companies to terminate their Tax-Credit ESOPs and distribute securities held by these plans without being in violation of the 84-month holding period rule contained in Code Section 409(d). Generally, a violation of the 84-month holding period rule would result in a recapture of tax credits previously taken by a company with respect to securities held by its Tax-Credit ESOP that are subject to the 84-month holding period rule, and would subject the company to other significant penalties.

Also, TRA'86 amended Section 72 of the Code to provide a 10% additional tax on early payments from a qualified plan, but under Section 72(t) of the Code, as amended, employees receiving distributions from ESOPs (including Tax-Credit ESOPs, according to statements in the TRA'86 Blue Book and the statutory language in the Technical Corrections bill) would generally be able to avoid the imposition of the 10% additional tax on early payments if the distribution occurs before 1990.

The clear understanding of Congress and employers when TRA'86 was passed (and payroll tax credits eliminated) was that employers that established Tax-Credit ESOPs for the benefit of their employees would not be required to maintain these plans for years when tax credits for company contributions to the plans would not be available to the companies. This relief was made available since Congress recognized that these plans are costly to administer, and that many employers would not have established them in the first place if a tax credit were not available.

Our experience supports Congress' conclusion that these plans, whether or not self-administered, are costly to administer for most companies. In providing this relief to companies and employees, Congress also recognized that an employee receiving a lump sum distribution from a terminated plan could roll over the taxable portion of the distribution into an IRA or another qualified plan (if that plan accepts rollovers) on a tax-free basis. Thus, with the rules discussed above in place, the concerns of both employers and employees in this area were satisfied when TRA'86 was enacted.

Many employers have relied on these TRA'86 rules, which are clear, unequivocal and coherent, and have already terminated their Tax-Credit ESOPs and have distributed account balances to employees or at an employee's direction have transferred the employee's account balance to the employer's profit sharing plan. These direct transfers are specifically authorized by the TRA'86 Blue Book.

Other employers have terminated their Tax-Credit ESOPs, but have not yet distributed ESOP account balances to employees. Many employers have decided to terminate their Tax-Credit ESOPs and have announced their decision to employees, but have not yet taken formal action to terminate the plan. Other employers are planning to terminate their Tax-Credit ESOPs in the near future. Some employers are, of course, still considering what steps to take and have made no decisions.

## The Proposed Amendments

With this as background, we now note that the Technical Corrections bill, which was introduced in Congress on June 10, 1987, would once again amend Code Section 409(d)(1). These latest amendments to Code Section 409(d)(1) would provide relief from the 84-month holding period rule, but only if a Tax-Credit ESOP is terminated without the establishment of a successor plan and the amount distributed from the terminated Tax-Credit ESOP is a lump sum distribution within the meaning of Code Section 401(k)(10). This Code Section would be added to the Code by the Technical Corrections bill. Since employers do not generally contemplate establishing successor plans for their Tax-Credit ESOPs and the payments of an employee's account would be made in a single lump sum anyway, these amendments would not appear to be a major concern.

However, at a recent meeting a legislative attorney on the staff of the Joint Committee on Taxation indicated that one definition of a successor plan being seriously considered would include any qualified defined contribution plan maintained by the employer without regard to when that plan was adopted. If the language in the Technical Corrections bill is interpreted in this manner, it would effectively mean that very few, if any, employers could terminate their Tax-Credit ESOPs before the 84-month holding period rule, applicable to the securities in the plan, expires -- since virtually all of the employers with Tax-Credit ESOPs also maintain other qualified defined contribution plans. Clearly, this cannot be Congressional intent.

Furthermore, it appears these amendment changes to Code Section 409(d)(1) would be retroactive to the effective date of TRA'86. We believe that any amendment that changes the original TRA'86 provisions pertaining to Tax-Credit ESOPs would be outrageous and a breach of faith by Congress with the employers and organizations representing employers throughout this nation.

Again, as previously mentioned, Tax-Credit ESOPs, whether or not self-administered, are often expensive for companies to administer. This added expense will be even more significant when one considers that there no longer is any reason for the establishment and continuation of the plan since the tax credit available for contributions to the plan has expired. We frankly believe that Congress understood these concerns and in TRA'86 specifically allowed employers to terminate their Tax-Credit ESOPs -- without being subject to the 84-month rule -- and allowed employees significant flexibility in their handling of Tax-Credit ESOP distributions (e.g., to make tax-free rollovers of taxable monies to an IRA or to direct transfers of these amounts to other plans of the employer).

## Conclusion

As we see it, there is absolutely no reason to change the rules at this time. Many employers have already terminated their Tax-Credit ESOPs and distributed account balances to employees or at the employee's direction transferred account balances to the employer's profit sharing plan. Others have taken formal action to terminate their Tax-Credit ESOPs, but have yet to distribute account balances. Neither these employers nor other employers that plan to terminate their Tax-Credit ESOPs in the future should be adversely affected. This was clearly the concept approved by Congress in TRA'86 and there is no reason to change it.

Thus, we strongly urge that the Technical Corrections changes to Code Section 409(d)(1) of TRA'86 should be dropped, or, in the alternative, the phrase "successor plan" should be defined to refer only to an ESOP newly established by an employer. In any event, no conditions should be imposed on the transfer of an employee's existing balance -- at the employee's direction -- under a terminated Tax-Credit ESOP to another qualified plan of the employer. In light of the penalties involved, other results would be punitive.

Clearly, at the very least, no employer who has already taken action with regard to terminating its Tax-Credit ESOP (e.g., the employer has already sent out employee announcements concerning the termination) should be adversely affected.

Very truly yours,

Frederick W. Rumack

Frederick W. Rumack
Director of Tax and Legal Services

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July 27, 1987

Robert Leonard
Chief Counsel
Committee on Ways and Means
United States House of Representatives
Longworth Office Building
Washington, D. C. 20515

Re: Section 111B(i), H.R. 2636/S. 1350,
Technical Corrections Act of 1987

Dear Mr. Leonard:

We join the reported position of numerous other commentors on the provisions of Section 111(B)(i) of H.R. 2636/S. 1350, that a "technical correction" should not be made to limit distributions in the case of termination of a tax credit ESOP under section 409(d)(1) of the Internal Revenue Code of 1986.

In particular, it is respectfully submitted that a limitation or denial of distributions upon termination of a tax credit ESOP because the employer has a separate and pre-existing defined contribution plan is not consistent with the legislative history of the Tax Reform Act of 1986.

The intendment of Section 1174(a)(1) of the Tax Reform Act of 1986, is to promote administrative ease and reduce complexity in the tax laws by eliminating the tax credit ESOP distribution restrictions in any case of termination.

The proposed change will have the opposite effect. It will unduly complicate planning for employee benefits by both employers and employee participants, especially in cases where employers have already initiated the restructuring of their benefit programs to take into account the ESOP rules enacted by the Tax Reform Act of 1986.

If this type of change is to be made by a technical correction, a grandfather provision or exception should certainly be afforded to permit employers to proceed with distributions pursuant to ESOP terminations which have been effected or authorized prior to the enactment of a Technical Corrections Act.

In addition, a distribution upon tax credit ESOP termination at a participant's election should be allowed in any case where the participant may also elect, in the alternative, to have distribution deferred by rollover or transfer of ESOP assets to the trust of another qualified employer plan. That approach will permit a terminated tax credit ESOP participant to continue with qualified plan retirement savings. At the same time, there will be more uniformity in treatment of plans, and employers will not be arbitrarily burdened with a requirement of maintaining and administering duplicative plans, which, after an otherwise permissible ESOP termination, will not provide measurable additions to benefits in the form of stock ownership or savings.

Very truly yours,

Sheppard F. Miers, Jr.
For the Firm

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July 17, 1987

Robert J. Leonard
Chief Counsel
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Re: Technical Corrections Act of 1987

Dear Rob:

We appreciate the opportunity to provide our comments on the Technical Corrections Act of 1987, on behalf of Levi Strauss & Co. In particular, we are commenting on the proposed technical correction to Section 1174 of the Tax Reform Act of 1986. The technical correction would change Section 409(d)(1) of the Code which currently provides an exception from the 84-month holding rule for employer securities by a tax credit ESOP.

As more fully discussed in the attached outline of our comments, we believe the proposal should not be adopted in its current form, and in any event, any proposed new rules should be adopted only for terminations after the date of introduction of the rules.

We welcome the opportunity to discuss this issue with your staff.

Very truly yours,

David

David W. Hardee, P.C.
Howard L. Clemons

# THE TECHNICAL CORRECTIONS ACT SHOULD NOT RESTRICT THE ABILITY TO TERMINATE A TAX CREDIT ESOP UNDER SECTION 409(d)(1)

## Tax Reform Act of 1986

The Tax Reform Act of 1986, amended section 409(d)(1) of the Code to allow distributions of employer securities on termination of a tax credit ESOP without regard to the 84-month holding period rule. Congress intended that this exception apply if amounts held by the ESOP are distributed to participants, transferred to another plan or rolled over when the tax credit ESOP is terminated. This change was made because the 84-month rule derived from the 7 year investment tax credit recapture period and in view of the ESOP credit having been changed to a payroll based credit, Congress "saw no purpose" in requiring a terminated tax credit ESOP to continue to exist solely to hold assets under the 84-month rule.

## Technical Corrections

Section 111B(i) of the Technical Corrections Act of 1987 (S. 1350, H. 2636) (the "TCA") would replace the exception for "termination of the plan" with an exception for a "lump-sum distribution (within the meaning of section 401(k)(10)(B)(ii)) upon the termination of a plan without the establishment of a successor plan." The proposed technical correction severely cuts back the coverage of the existing provision by imposing additional technical requirements. In particular, the proposed technical correction creates the following problems:

1. The foremost problem is that the technical correction is proposed to be effective for all transactions covered by the Tax Reform Act provision, including those completed prior to introduction of the technical correction. Since these transactions cannot be restructured to comply with a new rule, any change to the provision should be effective only for plan terminations following the date of the introduction of the bill.

2. The requirement for a lump sum distribution (within the meaning of section 401(k)(10)(b)(ii) as added by the Technical Corrections Act) places the following additional restrictions on use of the exemption:

> A lump sum distribution requires the distribution of the participant's full account balance to be made within one taxable year. Tax credit ESOPs maintained by large corporations have thousands of participants. Merely because of administrative problems, it is likely that a few accounts will not be fully distributed in one taxable year. Even one such failure would prevent the provision from being available. It makes no sense to condition the availability of the exemption from the 84-month rule on this distribution requirement.
>
> A lump sum distribution also requires that each participant receive a distribution of his or her account balance in the tax credit ESOP and all other stock bonus plans. Section 402(e)(4)(C). Therefore, the relief would not be available to an employer that also provides its employees with benefits under another stock bonus plan. Eliminating the exemption when the employer provides these additional benefits imposes a penalty with no useful purpose.

The requirement that accounts be distributed also precludes the employer from transferring account balances to other qualified plans. This rule directly contradicts the legislative history which permits amounts to be "distributed, transferred to another plan, or rolled over" upon plan termination. Since the rollover of an actual distribution produces substantially the same effect as a plan-to-plan transfer, preventing transfers simply imposes an unwarranted administrative burden on both the plan sponsor and participants.

The prohibition on the existence of a "successor plan" is unnecessary. The term is undefined. The major concern of a "successor plan" rule is to prevent taxpayers from terminating a plan and starting a new one just to avoid the restrictions on distributions. But this is not a concern here (as it is with 401(k) plans) because a new plan cannot be established to get the tax credit. If a "successor plan" for purposes of the exemption could be more than a tax credit ESOP, then this rule would be directly contrary to the Congressional intent that plan-to-plan transfers be available.

Proposals

The proposed technical correction is not necessary and should be removed. The original provision was intended to provide an exemption from the 84-month stock holding rule for those corporations terminating a tax-credit ESOP. As proposed in the TCA, the ability to terminate a tax-credit ESOP would be seriously restricted. Even if some form of technical corrections is desirable, the provision should be effective no sooner than the date of its introduction. Past transactions should be governed by the statute as enacted in the Tax Reform Act.

AUG 03 REC'D

**Oklahoma Natural Gas Company**
*A Division of ONEOK Inc.*

**L. H. Enloe**
*Vice President*
*Personnel*

July 28, 1987

The Honorable Mike Synar
House of Representatives
2441 Rayburn House Office Building
Washington, D.C. 20515

Dear Representative Synar:

SECTION 111B(i), H.R. 2636
TECHNICAL CORRECTIONS ACT OF 1987

A copy of my letter to Mr. Robert Leonard, chief counsel, Committee on Ways and Means, concerning the Technical Corrections Act of 1987 is attached.

Any assistance you can render in this matter will be sincerely appreciated.

Sincerely,

L.H. Enloe
L. H. Enloe

Attachment

*Post Office Box 871, Tulsa, OK 74102-0871 • 100 West Fifth Street • (918) 588-7922*

**Oklahoma Natural Gas Company**
*A Division of ONEOK Inc.*

*L. H. Enloe*
*Vice President*
*Personnel*

July 27, 1987

Mr. Robert Leonard
Chief Counsel
Committee on Ways and Means
United States House of Representatives
Longworth Office Building
Washington, D.C. 20515

Dear Mr. Leonard:

SECTION 111B(i), H.R. 2636
TECHNICAL CORRECTIONS ACT OF 1987

I am writing concerning the provisions of Section 111(B)(i) of H.R. 2636 that would make a "technical correction" limiting distributions in case of a tax credit ESOP plan termination under Section 409(d)(i) of the Internal Revenue Code of 1986. Our parent company, ONEOK Inc., has a tax credit ESOP with approximately 2,300 participants, including the 2,040 employees of Oklahoma Natural Gas Company.

We do not believe this technical correction should be made. It was the intent of the Tax Reform Act of 1986 to promote administrative ease and reduce complexity in the law by eliminating the tax credit ESOP distribution restrictions in any case of termination. It will unduly complicate our employee benefits planning because on June 18, 1987, our company initiated restructuring of its defined contribution benefits programs to take into account the ESOP rules enacted by TRA 1986.

If this type of change is to be made by a technical correction, a grandfather provision or exception should certainly be afforded to permit employers to proceed with distributions pursuant to ESOP terminations which have been effected or authorized prior to the enactment of a Technical Corrections Act.

In addition, a distribution upon tax credit ESOP termination at a participant's election should be allowed in any case where the participant may also elect, in the alternative, to have distribution deferred by rollover or transfer of ESOP assets to the trust of another qualified employer plan. These are the specific provisions made for the termination of our ESOP which becomes effective August 31, 1987.

Enactment of the technical correction limiting distributions will cause this company undue administrative hardships and arbitrarily burden it with maintaining duplicative plans. Many other employers must surely be affected the same way.

We trust you will take the foregoing into consideration during formulation of a Technical Corrections Act.

Sincerely,

L. H. Enloe

L. H. Enloe
Vice President - Personnel

**ONEOK Inc.**

**P. A. Wimpey**
*Senior Vice President,*
*Chief Financial Officer,*
*and Treasurer*

July 28, 1987

Mr. Robert Leonard, Chief Counsel
Committee on Ways and Means
United States House of Representatives
Longworth Office Building
Washington, D.C. 20515

Dear Mr. Leonard:

SECTION 111B(i), H.R. 2636
TECHNICAL CORRECTIONS ACT OF 1987

We join the reported position of numerous other commentors on the provisions of Section 111(B)(i) of H.R. 2636 that a "technical correction" should not be made to limit distributions in the case of plan termination under section 409(d)(1) of the Internal Revenue Code of 1986.

In particular, such a limitation or denial of distributions upon plan termination, if a separate defined contribution plan of the employer already exists, is not reflective of the legislative history of the Tax Reform Act of 1986.

The intendment of Section 1174(a)(1) of the Tax Reform Act of 1986, was to promote administrative ease and reduce complexity in the tax laws by eliminating the tax credit ESOP distribution restrictions in any case of termination.

The proposed change will unduly complicate planning for employee benefits by both employers and employee participants, especially in cases where employers have already initiated the restructuring of their benefit programs to take into account the ESOP rules enacted by the Tax Reform Act of 1986.

If this type of change is to be made by a technical correction, a grandfather provision or exception should certainly be afforded to permit employers to proceed with distributions persuant to ESOP terminations which have been effected or authorized prior to the enactment of a Technical Corrections Act.

In addition, a distribution upon tax credit ESOP termination at a participant's election should be allowed in any case where the participant may also elect, in the alternative, to have distribution deferred by rollover or transfer of ESOP assets to the trust of another qualified employer plan. That approach will permit a terminated tax credit ESOP participant to continue with qualified plan retirement savings. At the same time, there will be more uniformity in treatment of plans, and the employers will not be arbitrarily burdened with a requirement of maintaining and administering duplicative plans, which, after an otherwise permissible ESOP termination, will not provide measurable additions to benefits in the form of stock ownership or savings.

Sincerely,

P. A. Wimpey

P. A. Wimpey
Senior Vice President,
Chief Financial Officer,
and Treasurer

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July 16, 1987

EXPRESS MAIL

Robert J. Leonard, Esq.
Chief Tax Counsel
Committee on Ways and Means
1111 Longworth House Office Building
Washington, D.C. 20515

Re: Section 111B(i)(1) of the Proposed Technical Corrections Act of 1987 -- Transfers of Proceeds to Other Qualified Plans Upon Termination of Certain Employee Stock Ownership Plans

Dear Mr. Leonard:

In response to Chairman Rostenkowski's invitation for comments on the proposed Technical Corrections Act of 1987 (H.R. 2636, S. 1350), as introduced on June 10, 1987 ("TCA"), I am writing to call your attention to the provision contained in TCA section 111B(i)(1). As explained below, we believe the proposed correction does not reflect clearly the legislative intent of the provision of the Tax Reform Act of 1986 ("TRA") to which it relates.

In general, in order to meet the requirements of present section 409(d) of the Internal Revenue Code of 1986 (the "Code"), as amended by TRA section 1174(a)(1), a payroll-based tax-credit employee stock ownership plan (a "tax-credit ESOP") must provide, among other things, that:

> no employer security allocated to a participant's account . . . may be distributed from that account before the 84th month beginning after the month in which the security is allocated to the account. To the extent provided in the plan, the preceding sentence shall not apply in the case of --
>
> (1) death, disability, separation from service, or termination of the plan. . . .

The exception to the so-called "84-month rule" in the case of a "termination of the plan" was added by TRA section 1174(a)(1).

The General Explanation of the Tax Reform Act prepared by the Joint Committee on Taxation (the "Blue Book") makes clear that Congress intended to permit, upon the termination of a tax-credit ESOP, the sale of allocated employer securities and the subsequent transfer of the proceeds to another existing qualified plan:

> Under [TRA], distributions from a tax-credit ESOP are permitted upon the plan's termination provided no successor plan is established regardless of whether the 84-month rule has been satisfied. [TRA] provides that the sale of securities held by a tax-credit ESOP, and the transfer of those proceeds to another qualified plan, is permitted upon the termination of the ESOP. Blue Book, p. 715 (emphasis added).

Distributions upon termination of a tax-credit ESOP were also discussed in the Blue Book, at page 838, where it was stated that a technical correction might be required with respect to (1) the "successor plan" rule referred to at page 715, and (2) the requirement (not contained in TRA) that qualifying termination distributions must consist of the entire balance to the credit of the participant. It would appear that section 111B(i)(1) was intended to make technical corrections to address these problems.

Although TCA section 111B(i)(1) does address these two problems, it also appears to obscure the congressional intent as enunciated in the Blue Book at page 715 to permit assets to be transferred directly to another existing qualified plan. In this connection, Code section 409(d)(1), as proposed to be amended by TCA section 111B(i)(1), would not except from the 84-month rule any termination distribution, but rather would limit the exception to "lump-sum distribution[s] . . . upon the termination of a plan without the establishment of a successor plan." We respectfully submit that the reference to a "lump-sum distribution" in proposed section 409(d)(1) could be interpreted to require distributions directly to participants, in derogation of the clear intent to permit direct transfers of cash (and, *a fortiori*, stock transfers) to other qualified plans. Thus, with respect to direct transfers, the proposed TCA section 111B(i)(1) amendment of Code section 409(d)(1) could effect a substantive change that would result in the retroactive imposition of severe adverse tax consequences in the case of transactions that have occurred in reliance on the existing statutory language. *See* TRA § 1171(c)(2).

It should also be noted that a lump-sum distribution generally consists of a total distribution from all similar plans maintained by a plan sponsor (*see* Code § 402(e)(4)(C)). Thus, if section 409(d)(1) were to be amended as proposed by TCA section 111B(i)(1), a distribution in connection with a plan termination of a tax-credit ESOP, where another plan of the same type is also maintained by the same sponsor covering the same participants, might not be permitted. There is no indication in any of the legislative history of TRA that Congress intended not to allow distributions from a terminating stock bonus (or other type of) tax-credit ESOP where the sponsor also maintains a second stock bonus (or such other type of) plan.

To avoid these results, we would suggest as an alternative that TCA section 111B(i)(1), as currently drafted, be replaced by the following provision (marked to indicate our proposed additions):

> (1) Paragraph (1) of section 409(d) of the 1986 Code (relating to securities must stay in the plan) is amended by striking out "*or* termination of the plan" and inserting in lieu thereof "lump-sum distribution (within the meaning of section 401(k)(10)(B)(ii)*, determined without reference to section 402(e)(4)(C)*) upon termination of a plan without the establishment of a successor plan*, or direct transfer of the balance of such account, to a trust exempt from tax under section 501(a) established under a plan described in section 401(a), upon termination of a plan without the establishment of a successor plan*".

We will be available to meet with you to discuss any questions you may have with respect to the foregoing.

Respectfully submitted,

Evelyn A Petschek

Evelyn A. Petschek

Andrew L. Oringer

Public Service
Electric and Gas
Company

**Parker C. Peterman**
Vice President and Comptroller

80 Park Plaza, Newark, NJ 07101 201-430 6161 Mailing Address P.O. Box 570, Newark, NJ 07101

August 27, 1987

The Honorable Dan Rostenkowski
Chairman, Ways and Means Committee
U. S. House of Representatives
1102 LHOB
New Jersey and Independence Avenues, S.E.
Washington, D. C. 20515

The Honorable Lloyd M. Bentsen
Chairman, Finance Committee
U. S. Senate
205 SDOB
Constitution Avenue and First Street, N. E.
Washington, D. C. 20510

Dear Chairmen:

On August 19, Frederick W. Rumack, Director of Tax and Legal Services for Buck Consultants, Inc. wrote you objecting to proposed changes to Internal Revenue Code section 409(d)(1) contained in the Technical Corrections bill (H.R. 2636 and S.1350). Public Service Electric and Gas Company supports Mr. Rumack's position with respect to the proposed Technical Corrections changes.

Public Service has maintained an investment tax credit ESOP since 1975 and a separate payroll-based ESOP since 1983. No employer contributions to these plans will be made after 1986, although dividends will be credited quarterly and reinvested in additional employer stock. In addition, administrative costs would continue to be incurred as long as the plans were in operation. Therefore, based on the Tax Reform Act of 1986, planning was under way to terminate both plans as of December 31, 1987 with employees to be given the option of either receiving the shares held in their account as of the termination date or to roll over their account balances into the company's continuing Thrift and Tax-Deferred Savings Plan. We had planned an extensive communications program to employees in the last quarter of 1987 so that they could make the most informed choice depending on individual financial circumstances. With the current uncertainty in this matter, all efforts have been placed in a hold status pending legislative clarification.

In conclusion, we urge that the Code section 409(d)(1) changes contained in Technical Corrections be eliminated or, alternatively, that the term "successor plan" be defined to apply only to a newly established ESOP.

Very truly yours,

Parker Peterman

**Witco**

Witco Corporation, 520 Madison Avenue, New York, N.Y. 10022-4236 Telephone 212-605-3820

Paul M. Feeney
Vice-President
& Treasurer

September 1, 1987

The Honorable Dan Rostenkowski
Chairman, Ways & Means Committee
U. S. House of Representatives
1102 LHOB
New Jersey & Independence Avenues, S. E.
Washington, D. C. 20515

Dear Representative Rostenkowski:

We are writing to express the deep concern of Buck Consultants and its clients about the proposed amendments in the Technical Corrections bill (H.R. 2636, S. 1350) to Section 1174 of the Tax Reform Act of 1986 (TRA'86) and an interpretation being given to these amendments that retroactively would effectively preclude a company from terminating its Tax-Credit ESOP for seven or more years. This interpretation is apparently being seriously discussed in Washington.

Buck Consultants, Inc., a leading employee benefits consulting firm, has many clients that maintain Tax-Credit ESOPs. They would be adversely affected if these amendments are adopted and regulations on these amendments adopt this interpretation and preclude termination of these plans for seven or more years. This would be an extreme breach of faith -- based on the understanding of employers and Congress when TRA'86 was enacted.

## Congressional Intent

As originally enacted, TRA'86 amended Code Section 490(d)(1) to allow companies to terminate their Tax-Credit ESOPs and distribute securities held by these plans without being in violation of the 84-month holding period rule contained in Code Section 409(d). Generally, a violation of the 84-month holding period rule would result in a recapture of tax credits previously taken by a company with respect to securities held by its Tax-Credit ESOP that are subject to the 84-month holding period rule, and would subject the company to other significant penalties.

Also, TRA'86 amended Section 72 of the Code to provide a 10% additional tax on early payments from a qualified plan, but under Section 72(t) of the Code, as amended, employees receiving distributions from ESOPs (including Tax-Credit ESOPs, according to statements in the TRA'86 Blue Book and the statutory language in the Technical Corrections bill) would generally be able to avoid the imposition of the 10% additional tax on early payments if the distribution occurs before 1990. The clear understanding of Congress and employers when TRA'86 was passed (and payroll tax credits eliminated) was that employers that established Tax-Credit ESOPs for the benefit of their employees would not be required to maintain these plans for years when tax credits for company contributions to the plans would not be available to the companies. This relief was made available since Congress recognized that these plans are costly to administer, and that many employers would not have established them in the first place if a tax credit were not available.

Our experience supports Congress' conclusion that these plans, whether or not self-administered, are costly to administer for most companies. In providing this relief to companies and employees, Congress also recognized that an employee receiving a lump sum distribution from a terminated plan could roll over the taxable portion of the distribution into an IRA or another qualified plan (if that plan accepts rollovers) on a tax-free basis. Thus, with the rules discussed above in place, the concerns of both employers and employees in this area were satisfied when TRA'86 was enacted.

Many employers have relied on these TRA'86 rules, which are clear, unequivocal and coherent, and have already terminated their Tax-Credit ESOPs and have distributed account balances to employees or at an employee's direction have transferred the employee's account balance to the employer's profit sharing plan. These direct transfers are specifically authorized by the TRA'86 Blue Book.

Other employers have terminated their Tax-Credit ESOPs, but have not yet distributed ESOP account balances to employees. Many employers have decided to terminate their Tax-Credit ESOPs and have announced their decision to employees, but have not yet taken formal action to terminate the plan. Other employers are planning to terminate their Tax-Credit ESOPs in the near future. Some employers are, of course, still considering what steps to take and have made no decisions.

## The Proposed Amendments

With this as background, we now note that the Technical Corrections bill, which was introduced in Congress on June 10, 1987, would once again amend Code Section 409(d)(1). These latest amendments to Code Section 409(d)(1) would provide relief from the 84-month holding period rule, but only if a Tax-Credit ESOP is terminated without the establishment of a successor plan and the amount distributed from the terminated Tax-Crédit ESOP is a lump sum distribution within the meaning of Code Section 401(k)(10). This Code Section would be added to the Code by the Technical Corrections bill. Since employers do not generally contemplate establishing successor plans for their Tax-Credit ESOPs and the payments of an employee's account would be made in a single lump sum anyway, these amendements would not appear to be a major concern.

However, at a recent meeting a legislative attorney on the staff of the Joint Committee on Taxation indicated that one definition of a successor plan being seriously considered would include any qualified defined contribution plan maintained by the employer without regard to when that plan was adopted. If the language in the Technical Corrections bill is interpreted in this manner, it would effectively mean that very few, if any, employers could terminate their Tax-Credit ESOPs before the 84-month holding period rule, applicable to the securities in the plan, expires -- since virtually all of the employers with Tax-Credit ESOPs also maintain other qualified defined contribution plans. Clearly, this cannot be Congressional intent.

Furthermore, it appears these amendment changes to Code Section 409(d)(1) would be retroactive to the effective date of TRA'86. We believe that any amendement that changes the original TRA"86 provisions pertaining to Tax-Credit ESOPs would be outrageous and a breach of faith by Congress with the employers and organizations representing employers through this nation.

Again, as previously mentioned, Tax-Credit ESOPs, whether or not self-administered, are often expensive for companies to administer. This added expense will be even more significant when one considers that there no longer is any reason for the establishment and continuation of the plan since the tax credit available for contributions to the plan has expired. We frankly believe that Congress understood these concerns and in TRA'86 specifically allowed employers to terminate their Tax-Credit ESOPs -- without being subject to the 84-month rule -- and allowed employees significant flexibility in their handling of Tax-Credit ESOP distributions (e.g., to make tax-free rollovers of taxable monies to an IRA or to direct transfers of these amounts to other plans of the employer).

## Conclusion

As we see it, there is absolutely no reason to change the rules at this time. Many employers have already terminated their Tax-Credit ESOPs and distributed account balances to employees or at the employee's direction transferred account balances to the employer's profit sharing plan. Others have taken formal action to terminate their Tax-Credit ESOPs, but have yet to distribute account balances. Neither these employers nor other employers that plan to terminate their Tax-Credit ESOPs in the future should be adversely affected. This was clearly the concept approved by Congress in TRA'86 and there is no reason to change it.

Thus, we strongly urge that the Technical Corrections changes to Code Section 409(d)(1) of TRA'86 should be dropped, or, in the alternative, the phrase "successor plan" should be defined to refer only to an ESOP newly established by an employer. In any event, no conditions should be imposed on the transfer of an employee's existing balance -- at the employee's direction -- under a terminated Tax-Credit ESOP to another qualified plan of the employer. In light of the penalties involved, other results would be punitive.

Clearly, at the very least, no employer who has already taken action with regard to terminating its Tax-Credit ESOP (e.g., the employer has already sent out employee announcements concerning the termination) should be adversely affected.

Finally, we note that, since it is standard procedure to distribute funds to terminated employees (without a 10% tax on early withdrawals) the proposed interpretation will become an incentive for certain employees to terminate in order to withdraw their funds from an otherwise inactive program.

Very truly yours,

WITCO CORPORATION

Paul M. Feeney
Vice-President & Treasurer